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No. _____

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In The

Supreme Court of the United States

October Term, 1992

IN RE: J. GREG SIKES,

Debtor.

J. GREG SIKES,

Petitioner,

vs.

BANCBOSTON MORTGAGE CORPORATION,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. CAN THE FRAUD OF ONE GENERAL PARTNER BE IMPUTED TO AN INNOCENT PARTNER FOR THE PURPOSE OF DENYING THE BANKRUPTCY DISCHARGEABILITY OF A DEBT OF THE INNOCENT PARTNER PURSUANT TO SECTION 523(a)(2)(A) OF THE BANKRUPTCY CODE?

II. IF FRAUD CAN BE IMPUTED FOR DENYING THE DISCHARGEABILITY OF A DEBT OF AN INNOCENT PARTNER, IS THE INNOCENT PARTNER ENTITLED TO PROCEDURAL DUE PROCESS TO PRESENT HIS CASE IN OPPOSITION TO THE CREDITOR'S REQUIRED SHOWINGS UNDER SECTION 523(a)(2)(A)?

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Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

Petitioner, J. Greg Sikes, respectfully prays that a Writ of Certiorari be issued to review the decision and opinion of the United States Court of Appeals for the Sixth Circuit entered in this matter on July 31, 1992.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit has been reported at 970 F.2d 1556 (6th Cir. 1992) and is attached hereto at Appendix App. 1. The

Sixth Circuit order denying the Petition to Rehear, which has not been reported, is attached hereto at Appendix App. 13.

The Memorandum Opinion of the United States District Court for the Middle District of Tennessee has been reported at 127 Bankr. 175 (M.D. Tenn. 1991) and is attached hereto at Appendix App. 15.

The Memorandum Opinions and Orders of the United States Bankruptcy Court for the Middle District of Tennessee have not been reported and are attached hereto at Appendix App. 39.

JURISDICTION

The decision of the United States Court of Appeals for the Sixth Circuit was entered on July 31, 1992. A timely Petition for Rehearing was denied on September 17, 1992. This Petition for a Writ of Certiorari was filed within 90 days of that date. Petitioner invokes the jurisdiction of this Court as set forth in 28 U.S.C. § 1254 and seeks the issuance of the Writ of Certiorari pursuant to Supreme Court Rule 10.1(a) because, among other reasons, the Sixth Circuit Court of Appeals has rendered a decision in direct conflict with the decision of the Eighth Circuit Court of Appeals in *Walker v. Citizens State Bank of Maryville, Missouri*, 726 F.2d 452 (8th Cir. 1984) on the same issue.

STATUTORY PROVISION INVOLVED

United States Code, Title 11:

§ 523 Exceptions to Discharge

(a) The discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt –

. . .

(2) for money, property, services, or any extension, renewal, or refinancing of credit, to the extent obtained by –

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

. . . .

11 U.S.C. § 523(a)(2)(A).

CONSTITUTIONAL PROVISION INVOLVED

The Fifth Amendment to the Constitution of the United States provides:

> No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in land or naval forces, or in the Militia, when in actual service in time of war or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself,

nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

STATEMENT OF THE CASE[1]

Petitioner seeks review of a judgment of the Sixth Circuit Court of Appeals which affirmed the decision of the U.S. District Court for the Middle District of Tennessee to deny the dischargeability of the Petitioner's debt to the Respondent. The basis for federal jurisdiction in the first instance is that the Respondent's nondischargeability action brought in the Petitioner's bankruptcy in the U.S. Bankruptcy Court for the Middle District of Tennessee was a "core proceeding" pursuant to 28 U.S.C. § 157(b)(2)(I).

In early 1986, Thomas E. Ledford ("Ledford") and Petitioner, J. Greg Sikes ("Sikes" or "Petitioner") formed a limited partnership, known as Montclair, Ltd. ("Montclair"), to purchase land in Nashville, Tennessee and to erect and sell a 42-unit residential condominium complex thereon. Ledford was charged with the day-to-day decision-making responsibilities regarding Montclair's business. Ledford handled all marketing and development of

[1] The proceedings in this matter up to this point (Bankruptcy Court dischargeability trial, District Court appeal and Sixth Circuit appeal) have been consolidated with those of Thomas E. Ledford. These are, however, two separate bankruptcy cases and two separate adversary proceedings, and Mr. Ledford is not a party to this Petition.

the project. Sikes was a passive investor in Montclair whose sole role in the Montclair project consisted of obtaining certain letters of credit and executing a limited guaranty to the lender. Although a general partner, Sikes did not exercise any management authority or make any decisions on behalf of Montclair.

In April, 1986, Montclair executed loan documents for a loan to Montclair in the amount of one million six hundred thousand dollars ($1,600,000), payable to BancBoston Mortgage Corporation's ("BancBoston") predecessor in interest. This loan was to provide funds to acquire the land upon which the Montclair project was to be constructed. In October, 1986, the loan documents were amended to increase the principal amount of the loan to six million two hundred twenty-five thousand dollars ($6,225,000). The additional funds were to develop and construct the Montclair condominium project.

The loan to Montclair was a non-recourse loan. Ledford and Sikes each executed limited personal guaranties to BancBoston in the amount of one million one hundred thousand dollars ($1,100,000). The $1,100,000 guaranty was the extent of the risk which Sikes undertook in his role as passive investor. Because the loan was non-recourse, Sikes' liability was limited to the amount of his guaranty.

Pursuant to the terms of the amended loan documents, Montclair was required to obtain fourteen (14) executed contracts for the sale of the condominium units in the project as a condition of the disbursement of the construction loan proceeds. Upon presentation of the

required contracts, BancBoston was obligated to disburse the construction funds. With respect to the required "pre-sale" contracts, the loan documents required *inter alia* that: the contracts would be legally enforceable with bona fide third party purchasers; the contracts would be entered into upon forms approved by BancBoston; the contracts would comply with certain minimum sales price and earnest money deposit requirements; the contracts would not be changed, modified, extended, terminated or amended without the prior written consent of BancBoston; and Montclair would not do or fail to do any act which would enable the purchaser under a contract to terminate the contract without forfeiture of the purchaser's down payment or earnest money.

Ledford, as Montclair's "hands on" manager, was responsible for finding buyers for the condominium units and for obtaining the "pre-sale" contracts in the required form. By November, 1986 the required number of contracts were submitted by Ledford to BancBoston which approved the submitted contracts and disbursed the construction funds. During this period of time Sikes had absolutely no contact, written or oral, with any one from BancBoston; only Ledford in his role as "managing" partner communicated with BancBoston. It was subsequently learned that some of the contracts submitted by Ledford were fraudulent and/or contained impermissible contingencies.

Montclair ultimately defaulted on certain repayment terms and conditions of the loan documents. At this point BancBoston demanded payment from Sikes pursuant to his limited guaranty. This was the first communication or contact of any type between BancBoston and Sikes after

the execution of the loan documents approximately two years before. Following the BancBoston demand Sikes learned that Ledford had submitted fraudulent or non-conforming contracts to BancBoston. Sikes later learned that BancBoston may have had knowledge at the time of submission that some of the "pre-sale" contracts did not conform to the requirements of the loan documents. In May, 1988, BancBoston initiated an action in federal district court against Ledford and Sikes on their limited personal guaranties. On January 4, 1989, the District Court for the Middle District of Tennessee entered judgments in favor of BancBoston against Ledford and Sikes in the amount of $1,100,000 each. These judgments were based solely on their limited guaranty obligations; no issues of fraud were raised by BancBoston. Ledford and Sikes subsequently filed separate personal bankruptcies.

BancBoston filed separate nondischargeability complaints in the bankruptcies of Sikes and Ledford pursuant to Bankruptcy Code Section 523(a)(2)(A) alleging that *Ledford* had either misrepresented or failed to disclose certain material facts regarding the condominium unit "pre-sale" contracts provided by Ledford to BancBoston. There were no allegations by BancBoston that Sikes had misrepresented or failed to make material disclosures to BancBoston. Over the objection of counsel for Sikes, the trials of the dischargeability actions against Sikes and Ledford were consolidated by the Bankruptcy Court. At the close of BancBoston's proof, the Bankruptcy Court dismissed BancBoston's nondischargeability complaint against Sikes. The Bankruptcy Court specifically found that there was no evidence to prove that Sikes participated in or had knowledge of Ledford's actions. The

Bankruptcy Court further held that absent any evidence of actual fraud by Sikes, the fraud of Ledford could not be imputed to Sikes as a matter of law. (App. 42-43).

The nondischargeability trial against Ledford proceeded without the participation of Sikes and his counsel given the fact that the action had been dismissed as to Sikes. After Ledford presented his case, the Bankruptcy Court held that BancBoston had carried its burden of proof as to Ledford's actual fraud and the justifiable reliance thereon by BancBoston. The Bankruptcy Court held Ledford's debt to BancBoston to be nondischargeable because Ledford made material misrepresentations to BancBoston and further, that Ledford knew that certain of the "pre-sale" contracts did not comply with the terms of the documents and that these misrepresentations had caused BancBoston actual damages, which amounted to the total funds disbursed less any mitigation (sales proceeds from the Montclair project). (App. 47). Having been dismissed from the consolidated case at trial, Sikes never had the opportunity to offer evidence to refute BancBoston's showing of justifiable reliance on the submitted contracts.

Upon appeal to the U. S. District Court for the Middle District of Tennessee, the Bankruptcy Court's decision was reversed. (App. 38). The District Court held that Ledford's misrepresentations and actual fraud could be imputed to Sikes and thus, Sikes' debt (arguably even beyond the limited guaranty amount) to BancBoston was nondischargeable. Disturbingly, the District Court did not remand the matter to the Bankruptcy Court to allow Sikes to offer any proof. The District Court decision effectively denied Sikes his "day in court".

The Sixth Circuit Court of Appeals affirmed the District Court's decision on July 31, 1992, (App. 1) and on September 17, 1992 Sikes' request for a rehearing was denied. (App. 13). To this day Sikes has never had the opportunity to present his case in any court.

REASONS FOR GRANTING THE PETITION

SUMMARY OF ARGUMENT

There is a direct conflict between the U.S. Courts of Appeals as well as among various bankruptcy courts throughout the United States with regard to the issue of the imputation of fraud to deny the dischargeability of an innocent person's debt. Had the Petitioner been a debtor in the Eighth Circuit, rather than the Sixth, he would have been fully discharged from any liability to Banc-Boston.

This Court has not directly addressed the issue of the imputation of fraud to deny dischargeability of an innocent partner's debt in over 100 years. In light of the adoption of the Bankruptcy Code in 1978 and the present confused state of the law on this issue, the Court should issue the writ of certiorari and review this matter. This case presents questions of exceptional importance and significance with regard to the implementation and viability of long established principles and policies of the Bankruptcy Code, primarily, the Code's goal of offering the honest debtor a "fresh start". The imputation of fraudulent intent to an innocent debtor and the resulting nondischargeability of a debt have far reaching repercussions which are contrary to this goal.

Further, the Petitioner was denied his constitutional right to due process because he was never given the opportunity to offer his case to the court. The important policies and fundamental rights involved, coupled with the confused state of the law regarding this issue, mandate this Court's intervention.

ARGUMENT

I. The denial of an innocent debtor's discharge because of a partner's actual fraud is contrary to long standing principles and policies of federal bankruptcy law.

As early as 1877, this Court recognized that the bankruptcy laws relieved "the honest citizen [from] the burden of hopeless insolvency". *Neal v. Clark*, 95 U.S. 704, 709 (1877). This Court, as well as courts of appeals, district courts and bankruptcy courts across the country have reiterated this underlying principle of *Neal* numerous times. *See e.g., Local Loan Co. v. Hunt*, 292 U.S. 234, 244, 54 S. Ct. 695, 699, 78 L.Ed. 1230, 1235 (1934). Although there is no constitutional right to a discharge of debt, this long standing legislatively created right is now commonly regarded as an essential element of American bankruptcy law. *United States v. Kras*, 409 U.S. 434, 446, 93 S. Ct. 631, 34 L.Ed.2d 626 (1973). A bankruptcy discharge functions

as a final societal safety net for honest debtors[2]; however, in this case the safety net failed to protect the Petitioner with a resulting personal liability that he had no part in creating.

No one disputes that the benefit of a bankruptcy discharge should not be available to the dishonest debtor. For this reason, the Bankruptcy Code provides that certain types of reprehensible conduct as set forth in Section 727 are sufficient to deny a debtor a discharge in bankruptcy; similarly, certain types of misfeasances by a debtor specified in Section 523 may warrant excepting certain debts from discharge. *See e.g., In Re Wilson*, 12 Bankr. 363, 370 (Bankr. M.D. Tenn. 1981); *Birmingham Trust National Bank v. Case*, 755 F.2d 1474, 1477-(11th Cir. 1985) (noting that "by creating the fraud exception to discharge, Congress sought to discourage fraudulent conduct"). However, to facilitate the fresh start goal, this Court long ago established a rule of construction regarding the exceptions to discharge: exceptions are to be strictly construed in favor of the debtor. *Gleason v. Thaw*, 236 U.S. 558, 35 S.Ct. 287, 59 L.Ed 717 (1915). In this Court's decision in *Neal*, Justice Harlan, construing Section 33 of the Bankruptcy Act of 1867, a predecessor to Bankruptcy Code subsection 523(a)(2)(A), recognized that for a debt to be nondischargeable because it was created by "fraud", the fraud had to be "positive fraud, or fraud in fact, involving moral turpitude or intentional wrong

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[2] For an excellent and detailed discussion of the issues presented, see Resnicoff, *Is It Morally Wrong to Depend on the Honesty of Your Partner or Spouse? Bankruptcy Dischargeability of Vicarious Debt*, 42 Case W. Res. 147, 177 (1992).

. . . and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality." *Neal*, 95 U.S. at 709.

The Section 523 exceptions to discharge reflect a variety of moral values, many of which are conditional upon a factual finding of intent (willfulness) by the debtor-wrongdoer. Subsection 523(a)(4) deals with fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny; subsection 523(a)(6) deals with willful, malicious injury to another entity or property of another entity; and subsection 523(a)(9) deals with debt arising from judgment liability wherein the debtor was driving while intoxicated. The other exceptions to discharge under Section 523 are basically public policy type exceptions; *e.g.*, subsection 523(a)(5) which makes child support and alimony a nondischargeable debt.

To except a debt from discharge under Section 523(a)(2)(A), the creditor is required to prove *actual* fraud by the debtor. Actual fraud is contrasted with constructive fraud such as may occur in a fraudulent conveyance context (Bankruptcy Code Section 548) where transfers without fair consideration are presumed fraudulent. The draftsmen of the Bankruptcy Code appear to have been well aware of the distinction between actual and presumptive fraud and the effect thereof in the Code; Section 523 is directly responsive to the question of imputation of fraud in the dischargeability context. "Actual fraud" is required, not implied fraud or implied fraudulent intent. Nondischargeability of a vicarious debt pursuant to subsection 523(a)(2)(A) is completely inconsistent with the balance of Section 523 as well as the underlying goals of the Bankruptcy Code because it has punitive effect for the

innocent debtor, the very individual the Bankruptcy Code is trying to protect.

In *In re Ward*, 857 F.2d 1082 (6th Cir. 1988), the Sixth Circuit enunciated the requirements for debt discharge exception under Section 523(a)(2)(A), stating,

> a creditor must prove the following elements set forth in *In re Phillips*, 804 F.2d 930, 932 (6th Cir. 1986): "[T]he creditor must prove that the debtor obtained money through a material misrepresentation that at the time the debtor knew was false or made with gross recklessness as to its truth. The creditor must also prove the debtor's *intent* to deceive. Moreover, the creditor must prove it reasonably relied on the false representations and that its reliance was the proximate cause of loss. (citations omitted)"

Ward, 857 F.2d at 1083. (emphasis added).[3] Apparently, the Sixth Circuit's decision before the Court has imputed not only the fraud of Ledford to Sikes, but also Ledford's intent to deceive. This is the only way to reconcile *Ward* and *Phillips* with the decision here. Although, the imputation of intent is clearly contrary to the other exceptions to discharge, consistent application of this theory would, for example, also impute nondischargeable liability to the

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[3] Several other circuit courts have required this same intent element to be proven by a creditor objecting to dischargeability under § 523(a)(2)(A). *See e.g., In re Hunter*, 780 F.2d 1577, 1579 (11th Cir. 1986) (requires that "debtor made a false representation with the purpose and intention of deceiving creditor"; *In re Kimzey*, 761 F.2d 421, 423 (7th Cir. 1985) ("must prove that the debtor possessed scienter, i.e., an intent to deceive"); *In re Britton*, 950 F.2d 602 (9th Cir. 1991); *In re Foreman*, 906 F.2d 123 (5th Cir. 1990).

innocent partner of one who incurred liability as a result of driving on partnership business while intoxicated. Neither the Bankruptcy Code nor case law supports such a result.

The nondischargeability of Sikes' debt to BancBoston solely because of the actual fraud of Ledford vitiates bankruptcy's long established goal of providing an honest debtor a fresh start. The imputation of intent, which is the practical significance and effect of the Sixth Circuit decision, necessarily carries with it grave implications to the other exceptions to discharge of debt under Section 523. Such a holding and the resulting implications are contrary to this Court's rules of construction adopted to further the goals of the bankruptcy laws. This Court's intervention is necessary to insure that the Bankruptcy Code's purposes and goals are, not only advanced, but also protected from erosion.

II. Vicarious liability does not equate to nondischargeability.

The nondischargeability of a debt of an innocent partner should not be confused with the innocent partner's liability for his partner's fraud or wrongdoing. Vicarious liability (the creation of a debt) and the dischargeability of that liability/debt are two entirely different principles. Without question, under state agency or partnership law, Sikes is liable for the actual fraud of his partner, Ledford, to the extent the fraud was within the scope of the partnership business. However, a brief review of the policies behind a vicarious liability rule

reveals that none of these supports the denial of the bankruptcy discharge of such liability.

There are four primary policy explanations for the vicarious liability rule. These are:

(1) The principal has control over his agent;

(2) Typically an agent's principal is in a better position than the agent's victim to absorb or spread any loss;

(3) Theoretically, in the marketplace, the principal can factor in these costs through pricing; and

(4) With an agent's apparent authority to act for its principal, there exists a need for third parties to be able to rely on this authority.

See W. Page Keeton, *Prosser & Keeton on the Law of Torts*, § 69 at p. 500 (5th ed. 1984). None of these policies includes any assumption that the passive partner is morally liable in any way. None of these policies support the nondischargeability of vicarious debt of an otherwise innocent debtor. It is inappropriate to apply vicarious liability principles to the issue of bankruptcy debt dischargeability.

III. The decision of the Sixth Circuit here directly conflicts with a decision of the Eighth Circuit.

Article 1, section 8 of the United States Constitution provides for a uniform bankruptcy law throughout the United States. Presently, uniformity with regard to the application of Section 523(a)(2)(A) does not exist. If the

Petitioner had filed his bankruptcy in the Eighth Circuit, he would now be discharged from any liability to Banc-Boston. However, because Sikes filed bankruptcy in the Sixth Circuit, he faces nondischargeable liability to Banc-Boston in an amount which may prove to be several times the amount of his $1,100,000 limited guaranty.

In *Walker v. Citizens State Bank of Maryville, Missouri*, 726 F.2d 452, 454 (8th Cir. 1984), the Eighth Circuit properly held that "[p]roof that a debtor's agent obtains money by fraud does not justify the denial of a discharge to the debtor, unless it is accompanied by proof which demonstrates or justifies an inference that the debtor knew or should have known of the fraud." The facts in *Walker* are very similar to those before the Court. In *Walker*, a wife took control of her husband's hardware store when he became ill. During this time, the wife pledged fictitious accounts receivable to a bank which loaned the Walkers money based on the fictitious accounts. The bank objected to the husband's discharge based on the fraud of his wife. The Eighth Circuit affirmed the district court's holding that "more than the mere existence of an agent-principal relationship is required. . . . " *Id.* The Eighth Circuit remanded the matter to the bankruptcy court for proceedings to determine whether the husband was recklessly indifferent to his wife's fraudulent actions. *Walker*, 726 F.2d at 455. Upon remand the bankruptcy court made a factual finding that the husband indeed should have known of his wife's wrongdoing. *In re Walker*, 53 Bankr. 174, 182 (Bankr. W.D. Mo. 1985). The important point in the Eighth Circuit's decision is that some factual finding of knowledge or gross disregard by the husband was required to

determine that the vicarious liability was nondischargeable.

The Sixth Circuit decision here is in direct conflict with *Walker*.[4] Here the Bankruptcy Court made the factual finding that Sikes had no fraudulent intent and no knowledge of the fraudulent activity of Ledford, nor should Sikes have known of Ledford's fraud. These factual findings remained unchallenged. Nevertheless, the District Court and the Sixth Circuit have held Sikes' debt nondischargeable without review of these findings. The result clearly would have been the opposite under *Walker*. There are no distinguishing factors between the case before the Court and *Walker*. Some other courts have distinguished *Walker* on the basis that it involved a husband and wife. However, a reading of *Walker* makes it clear that there existed an agency/business relationship and not just a marital relationship.

The Sixth Circuit opinion before the Court does not try to distinguish *Walker*; rather, it ignores it. The Sixth

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[4] The Fifth Circuit has also recently decided a case which at least indirectly conflicts with the Eighth Circuit's decision in *Walker*. *Luce v. First Equip. Leasing Corp. (In re Luce)*, 960 F.2d 1277 (5th Cir. 1992) ("knowledge and actions" of husband imputed to wife to deny discharge of a debt of wife). A reading of *Luce*, however, indicates that the Fifth Circuit, at least implicitly, found some knowledge of the fraud or reckless disregard therefor by the wife. Further, the Fifth Circuit's own decision in *In re Allison*, 960 F.2d 481, 485 (5th Cir. 1992) is inconsistent with *Luce*. In *Allison*, the court did not impute the husband's fraud to the innocent wife; the court stated, "[c]onsidering the statutory requirement for fraud involving moral turpitude or intentional wrong, we perceive no basis for applying the agency fraud theory to [the wife]."

Circuit, as well as the Fifth Circuit in *Luce* and most courts which have imputed fraud in the vicarious liability context, have relied upon this Court's 1885 decision, *Strang v. Bradner*, 114 U.S. 555, 29 L.Ed. 248, S.Ct. 1038 (1885). In *Strang*, this Court held that an innocent partner of Strang was liable for Strang's fraudulent misrepresentations to the partnership creditor (vicarious liability) and also that the vicarious debt was nondischargeable. A reading of *Strang* reveals that the Court failed to distinguish between the principles of vicarious liability and the nondischargeability of that liability.

In *Strang*, the same Justice Harlan who authored *Neal* some eight years prior to *Strang*, cited *Neal* with approval and reiterated that the term "fraud" in defining the debts from which a bankrupt is not relieved by a discharge under the Bankruptcy Act, should be construed to mean positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, and not implied fraud or fraud in law, which may exist without the imputation of bad faith or immorality. *Strang*, 114 U.S. at 559. The Court found that the debt in question was created by positive fraud *"upon the part of Strang"*. *Id.* (emphasis added). The Court made the critical transition from Strang's positive fraud to the denial of his innocent partner's discharge by stating,

> we are of the opinion that [Strang's] fraud is to be imputed, for the purposes of this action, to all the members of his firm. The transaction between him and the plaintiffs is to be deemed a partnership transaction, because, in addition to his representation that the notes were for the benefit of his firm, he had, by virtue of his agency for the partnership, and as between the

> firm and those dealing with it in good faith, authority to negotiate for promissory notes and other securities for its use. Each partner was the agent and representative of the firm with reference to all business within the scope of the partnership. If, in the conduct of the partnership business, and with reference thereto, one partner makes false or fraudulent misrepresentations of fact to the injury of innocent persons who deal with him as representing the firm, and without notice of any limitations upon his general authority, his partners cannot escape *pecuniary responsibility* therefore upon the ground that such a misrepresentation was made without their knowledge. This is especially so when, as in the case before us, the partners, who were not themselves guilty of wrong, received and appropriated the fruits of the fraudulent conduct of their associate in business.

Id. (emphasis added). The above quoted language reflects the principles of vicarious liability as discussed in Section II of this Petition. Without doubt, Strang's partners should be liable ("pecuniary responsibility") for his fraud; however, it does not follow that this liability should be nondischargeable. The Court's reasoning does not seem to recognize the critical distinction.

Neal and *Strang* cannot be reconciled. One possible explanation for the Court's apparently inconsistent positions is that the bankruptcy law was in a period of upheaval and uncertainty when *Strang* was decided. The Bankruptcy Act of 1867 was repealed in 1878 and the Bankruptcy Act of 1898 had not yet been passed when *Strang* was decided. The Court, addressing a post discharge action on the debt, applied state law vicarious

liability principles to determine that the debt was not subject to the previous discharge.

It is important to note that the principles of *Neal* have consistently been reaffirmed by this Court. On the other hand, *Strang* has not been reaffirmed by this Court and only in the past year has it been cited as precedent by the two circuit courts of appeals. A review of the legislative history of Section 523(a)(2)(A) reveals that Congress intended to codify the *Neal* decision. "Subparagraph [(a)(2)(A)] is intended to codify current case law, *e.g.*, *Neal v. Clark*, 95 U.S. 704, 24 L.Ed. 586 (1877), which interprets "fraud" to mean actual or positive fraud rather than fraud implied in law. 124 Cong. Rec. 3998 (1978) (statement of Sen. DeConcini); 124 Cong. Rec. 32998 (1978) (statement of Rep. Edwards). It is clear that the goal of providing a fresh start to the innocent debtor is intended to be at the forefront of nondischargeability determination. *Strang* and the Sixth Circuit decision here are contrary to this policy.

The Sixth Circuit decision here, as well as the Fifth Circuit decision, *Luce*, conflict with other Court of Appeals decisions, which, although involving factual distinctions, nevertheless conflict on important dischargeability issues. In *In re Black*, 787 F.2d 503 (10th Cir. 1986), the Tenth Circuit recognized that the exceptions to debt discharge are to be construed narrowly and that Section 523(a)(2)(A) "includes only those frauds involving moral turpitude or intentional wrong, and does not extend to fraud implied in law which may arise in the absence of bad faith or immorality." *Black*, 787 F.2d at 505. The leading bankruptcy commentator has reinforced this position, stating, "fraud implied in law, which may exist

with imputation of bad faith or immorality, is insufficient." King, *Collier on Bankruptcy* ¶ 523.08, p. 523-58 (15th ed. 1992) This Court has also affirmed a narrow construction of the exceptions to discharge to fulfill the Congressional objective that the debtor receive "a new opportunity of life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt." *Lines v. Frederick*, 400 U.S. 558, 561, 35 S. Ct. 287, 290, 59 L. Ed. 717, 720 (1915); *Gleason*, 236 U.S. 558. The imputation of Ledford's fraud to Sikes for the purpose of denying Sikes' discharge of the BancBoston debt directly conflicts with this often repeated principle.

Bankruptcy courts across the country are divided in their interpretation of Bankruptcy Code Section 523(a)(2)(A). Some courts, like the Sixth Circuit in this case, have imputed the fraud of an agent to the principal under section 523(a)(2) based upon principles of agency law. *In re Smith*, 98 Bankr. 423 (Bankr. C.D. Ill. 1989); *In re Powell*, 95 Bankr. 236 (Bankr. S.D. Fla. 1989); *In re Figge*, 94 Bankr. 654 (Bankr. C.D. Cal. 1988); *In re Hosking*, 89 Bankr. 971 (Bankr. S.D. Fla. 1988) (principal responsible for his agents' submission of a fraudulent financial statement whether or not he knew or should have known of their fraud); *In re Paolino*, 89 Bankr. 453, 460 (Bankr. E.D. Ark. 1988) (". . . fraud is imputed to the principal for the purposes of section 523(a)(2)(A)"); *In re Beleau*, 35 Bankr. 259 (Bankr. D. R.I. 1983); *In re Lowther*, 32 Bankr. 638 (Bankr. W.D. Okla. 1983); *In re Shelton*, 28 Bankr. 218 (Bankr. E.D. Mo. 1983) (husband's fraud imputed to wife); *In re Newmark*, 20 Bankr. 842 (Bankr. E.D.N.Y. 1982); *In re Pettit*, 17 Bankr. 6 (Bankr. E.D. Ark. 1980) (debtor

responsible for misrepresentations made by his attorney); *In re Pommerer*, 10 Bankr. 935 (Bankr. D. Minn. 1981) (husband's fraud imputed to wife). *In re Warren*, 7 Bankr. 571 (Bankr. N.D. Ala. 1980) (debt arising from false pretenses of a partner, acting for the partnership, constitutes a nondischargeable claim as to the innocent partner).

Conversely, other bankruptcy courts, applying a narrow construction to the Section 523(a)(2)(A) exception, have declined to impute the fraud of an agent to the principal absent some evidence of the principal's direct participation in the fraudulent scheme. *In re Buck*, 75 Bankr. 417 (Bankr. N.D. Cal. 1987); *In re Klein*, 58 Bankr. 397 (Bankr. E.D. Pa. 1986) (evidence insufficient to "implicate" wife); *In re Norton*, 34 Bankr. 666, 668 (Bankr. D. Ariz. 1983) (no evidence that wife "made" the misrepresentations); *In re Benedict*, 15 Bankr. 671 (Bankr. W.D. Mo. 1981) (husband did not instruct wife to obtain loan and had no knowledge of loan application); *In re Curl*, 64 Bankr. 14 (Bankr. W.D. Mo. 1986) (no evidence that husband acted as wife's agent); *In re Steinman*, 61 Bankr. 368 (Bankr. W.D. Mo. 1986) (evidence insufficient to establish that husband acted as wife's agent); *In re Futscher*, 58 Bankr. 14, 17 (Bankr. S.D. Ohio 1985) (principal must "actively" commit an "immoral or inequitable act"); *In re Love*, 47 Bankr. 213, 216 (Bankr. W.D. Mo. 1985) (wife's conduct cannot be imputed to innocent husband who committed no act of "positive fraud or misrepresentation"); *In re Bursch*, 14 Bankr. 702 (Bankr. D. Ariz. 1981); *In re Brashears*, 12 Bankr. 136, 137 (Bankr. S.D. Miss. 1981) (section 523(a)(2)(A) is limited to actual fraud, rather than

implied fraud, and this limitation prevents the imputation of fraud to one who is not an "active participant" in the fraud).

A few courts, like the Eighth Circuit in *Walker* and the Bankruptcy Court in this case, have expressly rejected the doctrine that as a matter of law the fraud of an agent may be imputed to the principal under Section 523(a)(2)(A). These courts have required a factual showing that the principal either knew or should have known of the agent's fraud. *In re Lovich*, 117 F.2d 612 (2d Cir. 1941); *In re Stefanoff*, 106 Bankr. 251 (Bankr. N.D. Okla. 1989); *In re Shane*, 80 Bankr. 240 (Bankr. S.D. Fla. 1987); *In re Betz*, 64 Bankr. 248 (Bankr. N.D. Ohio 1986); *In re Bonefas*, 41 Bankr. 74 (Bankr. N.D. Iowa 1984); *In re Armstrong*, 54 Bankr. 399, 405 (Bankr. N.D. Ala. 1985) (knowledge of husband's misrepresentations will not be imputed to wife who had no "direct knowledge" of the facts surrounding the misrepresentations); *In re Anderson*, 29 Bankr. 184 (Bankr. N.D. Iowa 1983); *In re Gray*, 22 Bankr. 676 (Bankr. W.D. Wis. 1982).

The law with regard to debt nondischargeability through the imputation of fraud is in a state of complete disarray. There is a direct split between the Sixth and Eighth Circuit Courts of Appeals on this question. The confused state of the law has resulted in some bankruptcy courts relying on the principles of *Neal*, while other courts faced with nearly identical facts, rely on *Strang* and completely opposite results are reached. Such inconsistency in the application of a federal law, especially a law with such great importance as debt dischargeability must be remedied. A debtor such as Sikes should not be punished because he lives in Tennessee

instead of Missouri. The confused state of the law on such a vitally important issue requires this Court's intervention and guidance.

IV. The Due Process Clause requires that the Petitioner be given his day in court.

The Due Process Clause of the Fifth Amendment to the U.S. Constitution guarantees a party his day in court to defend an action against him. *Saunders v. Shaw*, 244 U.S. 317 (1916). The Sixth Circuit's failure to remand this case to the Bankruptcy Court deprived Sikes of his "day in court" and of the guaranteed procedural due process. Because Sikes was dismissed from the consolidated dischargeability trial after BancBoston's proof, he never had an opportunity to present any evidence which might have shown that BancBoston failed to prove any of the elements of Section 523(a)(2)(A). For example, Sikes may have been able to show collusion between Ledford and BancBoston with regard to the submitted "pre-sale" contracts; such proof would go directly to BancBoston's reliance on the fraudulent contracts (a required showing under Section 523(a)(2)(A)). This is evidence which Ledford himself might not offer. Sikes has been penalized because he had the good fortune of being dismissed at the trial level. The District Court's outright reversal rather than remand has deprived Sikes of his day in court and procedural due process of law.

If fraud can be imputed to an innocent partner to deny the dischargeability of a debt of that partner, due process certainly requires that the innocent partner at

least be given the opportunity to present his own independent evidence which may affect the final result. After Sikes was dismissed, the issue should have been viewed as though Sikes was not even a party to the determination of Ledford's dischargeability. The result may be that there is a re-trial of BancBoston's dischargeability action against Ledford. However, Sikes' due process rights and opportunity to have his day in court outweigh any risk of duplicate trials. This Court's intervention is necessary to guarantee Sikes and similarly situated debtors their constitutional right to due process.

CONCLUSION

For the reasons stated herein, a Writ of Certiorari should issue to the United States Court of Appeals for the Sixth Circuit.

Respectfully submitted,

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In re Thomas E. LEDFORD and J. Gregg Sikes, Debtors.

BancBOSTON MORTGAGE CORPORATION, Plaintiff-Appellee,

v.

Thomas E. LEDFORD (91-5649); J. Gregg Sikes (91-5594), Defendants-Appellants.

Nos. 91-5594, 91-5649.

United States Court of Appeals, Sixth Circuit.

Argued April 3, 1992.
Decided July 31, 1992.

Paul S. Davidson (argued and briefed), D. Reed Houk (briefed), Stokes & Bartholomew, Nashville, Tenn., for plaintiff-appellee.

Joseph P. Rusnak, Tune, Entrekin & White, William Caldwell Hancock (argued and briefed), Paul E. Jennings (argued and briefed), Nashville, Tenn., for defendants-appellants.

Before: KEITH and NELSON, Circuit Judges; and TIMBERS, Senior Circuit Judge.*

DAVID A. NELSON, Circuit Judge.

This is a bankruptcy case that involves the dischargeability of bank debt incurred by a partnership to build a condominium project. After the bank had

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* The Honorable William H. Timbers, Senior Circuit Judge for the Second Circuit, sitting by designation.

advanced the loan proceeds to the partnership in apparent reliance on the existence of a specified number of contracts for the purchase of individual condominium units, it turned out that the character of the contracts had been fraudulently misrepresented to the bank by one of the partners.

Two questions are presented: (1) whether the bankruptcy court erred in finding, as it did, that the bank acted reasonably in disbursing the money, and (2) whether, for purposes of determining dischargeability under 11 U.S.C. § 523(a)(2)(A), the fraud of one general partner should be imputed to a second general partner who had no actual knowledge of it. The district court answered no to the first question and yes to the second. We agree, and we shall affirm the judgment of the district court.

I

The debtors, Thomas Ledford and J. Gregg Sikes, M.D., were general partners in a venture formed for the purpose of constructing a condominium project in Nashville, Tennessee. Mr. Ledford was also the sole stockholder and president of a development company used by the partnership in this connection. The partnership's business was managed by Mr. Ledford, and Dr. Sikes was not involved in day-to-day operations.

BancBoston lent the partnership $1.6 million to buy the land on which the project was to be built, and the bank agreed to make a construction loan in the additional amount of $4.625 million. It is only the construction loan that concerns us here.

Disbursement of the construction funds was originally contingent on the partnership's submitting contracts for the purchase of 20 individual condominium units, with down payments of at least 10%. The bank was to take a security interest in the contracts, and the loan documents provided that the contracts could not be "contingent."

Apart from the value that the purchase contracts had as collateral, the bank viewed the contracts as a measure of market interest in the condominium project. BancBoston had previously financed another Ledford condominium development, and had required the submission of individual purchase contracts there for the same reasons.

Experiencing difficulty in finding the requisite number of buyers willing to sign contracts before the Nashville project was built, Mr. Ledford persuaded BancBoston to reduce the number from 20 to 14 and to reduce the required down payment from 10% to 7%. In return, the bank took a $100,000 letter of credit that was to remain in force until 20 contracts meeting the bank's approval had been executed. The parties also entered into formal agreements specifying that the contracts had to be legally enforceable and had to be prepared on a form provided by BancBoston.

Although 14 contracts were submitted by the agreed deadline, several of them were subject to undisclosed side agreements not in conformity with the loan agreement. Two of the contracts were signed as an accommodation to Mr. Ledford – one by a Ledford employee and the other by a friend of an employee. Neither of the

accommodation signers had any intention of actually going through with a purchase. The bankruptcy court found that Mr. Ledford had committed fraud, and this finding is not challenged on appeal. It was further found that Dr. Sikes did not know of the fraud.

BancBoston disbursed the construction funds to the partnership without contacting any of the prospective purchasers named in the contracts. The bankruptcy court found that the funds would not have been disbursed but for the bank's belief that 14 bona fide non-contingent purchase contracts were in existence. The court further found, by "clear and convincing evidence," that the bank acted reasonably in relying on the partnership's representations concerning the contracts.[1]

The condominium project was not completed on schedule, and by the time it was finally finished, all of the purchase contracts had expired. The partnership defaulted on its loans, and the two general partners filed for bankruptcy.

BancBoston contended that the claim it filed with respect to the construction loan was not dischargeable as to either partner, under 11 U.S.C. § 523(a)(2)(A), because

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[1] The Supreme Court has since held that a creditor need only prove the elements of nondischargeability by a preponderance of the evidence. *Grogan v. Garner*, ___ U.S. ___, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991). Because the burden of proof does not affect our analysis in this case, we need not decide whether *Grogan* should be given retroactive effect. We note, however, that at least two other circuits have applied *Grogan* retroactively. *In re Luce*, 960 F.2d 1277 (5th Cir.1992); *Milton v. Moore*, 964 F.2d 880 (9th Cir.1992).

the loan had been procured through fraud. The bankruptcy court agreed that Mr. Ledford was not entitled to a discharge, but held that Dr. Sikes was. The district court reversed the decision as to Dr. Sikes, concluding that knowledge of Ledford's fraud should be imputed to him as a matter of law. 127 B.R. 175.

Both Ledford and Sikes have appealed, contending that BancBoston's reliance on the 14 purchase contracts was unreasonable. Dr. Sikes also contends that his indebtedness is dischargeable in any event because of his lack of actual knowledge of Ledford's fraud.

II

The debtors argue that it was unreasonable for the bank to rely on the contracts because the bank admittedly made no independent inquiry into their authenticity. We think that the debtors are reading too much into the "reasonableness" requirement that our caselaw has interpolated into the text of § 523(a)(2)(A).

Section 523(a) provides, in pertinent part, that an individual debtor will not be discharged from any debt

> "(2) for money . . . to the extent obtained by –
>
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition; [or] (B) use of a statement in writing –
>
> (i) that is materially false;
>
> (ii) respecting the debtor's or an insider's financial condition;

> (iii) on which the creditor to whom the debtor is liable for such money . . . reasonably relied; and
>
> (iv) that the debtor caused to be made or published with intent to deceive. . . . "

Subparagraph (a)(2)(A), unlike (a)(2)(B), contains no explicit requirement that a creditor's reliance be reasonable. We have nonetheless required creditors asserting nondischargeability under § 523(a)(2)(A) to show that their reliance met a loose standard of reasonableness. *In re Phillips*, 804 F.2d 930, 933 (6th Cir.1986); *In re Ward*, 857 F.2d 1082 (6th Cir.1988).

The predecessor to the current § 523(a)(2), section 17(a)(2) of the Bankruptcy Act, did not require that a creditor's reliance be reasonable.[2] In deciding cases under Section 17(a)(2), however, the courts did consider the reasonableness of a creditor's asserted reliance as evidence bearing on the question whether the creditor had actually relied on the representation in question. See, *e.g.*, *In re Garman*, 643 F.2d 1252 (7th Cir.1980), *cert. denied*, 450 U.S. 910, 101 S.Ct. 1347, 67 L.Ed.2d 333 (1981). After § 523(a)(2)(B) of the Bankruptcy Code was enacted, we adopted the *Garman* approach for cases arising under that section. In doing so we noted that the explicit reasonableness requirement of § 523(a)(2)(B) was merely intended to incorporate the caselaw existing at the time of enactment.

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[2] Section 17(a)(2) excepted from discharge "liabilities for obtaining money . . . upon a materially false statement in writing respecting his [bankrupt's] financial condition made or published or caused to be made or published in any manner whatsoever with intent to deceive. . . . " *In re Taylor*, 514 F.2d 1370, 1372-73 (9th Cir.1975).

In re Martin, 761 F.2d 1163, 1166 (6th Cir.1985); *Knoxville Teachers Credit Union v. Parkey*, 790 F.2d 490 (6th Cir.1986).

In *In re Phillips*, 804 F.2d 930, 933 (6th Cir.1986), we concluded that even though there is no explicit reasonableness requirement in § 523(a)(2)(A), the approach spelled out in *Garman* and *Martin* applied to § 523(a)(2)(A) as well.[3] The reasonableness requirement of *Phillips* was not particularly rigorous; we viewed the requirement as a filter intended to isolate creditors who had acted in bad faith. *Id.* As the *Garman* court said, the decisions that refer to "reasonable" or justifiable reliance do not require the court to undertake a subjective evaluation of a creditor's lending policy and practices; the decisions teach only that dischargeability should not be denied where a creditor's asserted reliance would be so unreasonable as to negate any actual reliance. *Garman*, 643 F.2d at 1256. It was the test enunciated in *Garman* that we held appropriate under § 523(a)(2)(B), *In re Martin*,

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[3] The Courts of Appeals for the Fifth and the Eighth Circuits have declined to follow our reasoning in *Phillips*. *In re Allison*, 960 F.2d 481 (5th Cir.1992); *In re Ophaug*, 827 F.2d 340 (8th Cir.1987). In *Allison*, the Fifth Circuit held that "reasonable reliance is not, as a matter of law, required under section 523(a)(2)(A)." 960 F.2d at 485. The *Allison* court maintained that (1) "the plain letter and the legislative history of subparagraphs (A) and (B) demonstrate that they espouse separate and independent grounds for the discharge exception." and (2) that the Supreme Court's decision in *Grogan v. Garner* calls into question the reasoning of cases like *Phillips* that find the fresh start policy of the Bankruptcy Code outweighs the rights of creditors who have acted unreasonably. *Id.* This reading of *Grogan v. Garner* may or may not be correct; given the grounds on which our decision rests, we need not decide the question here.

761 F.2d at 1166, and it was the *Garman* test that we applied under § 523(a)(2)(A) in *Phillips*.

Whether a creditor's reliance was reasonable is a factual determination to be made in light of the totality of the circumstances. Among the circumstances that might affect the reasonableness of a creditor's reliance are: (1) whether the creditor had a close personal relationship or friendship with the debtor; (2) whether there had been previous business dealings with the debtor that gave rise to a relationship of trust; (3) whether the debt was incurred for personal or commercial reasons; (4) whether there were any "red flags" that would have alerted an ordinarily prudent lender to the possibility that the representations relied upon were not accurate; and (5) whether even minimal investigation would have revealed the inaccuracy of the debtor's representations. See *e.g.*, *Phillips*, 804 F.2d at 933; *Ward*, 857 F.2d at 1084; *Martin*, 761 F.2d at 1166-67; *Knoxville Teachers Credit Union*, 790 F.2d at 492-93; *Garman*, 643 F.2d at 1257-59.

In the case at bar, BancBoston (which had a previous business relationship with Mr. Ledford that had given the bank no reason to mistrust him) inspected the purchase contracts submitted by Ledford to ensure that they complied with the terms of the agreement. There were no "red flags" that should have alerted the bank to the fact that two of the contracts had been signed merely as an accommodation; on the face of the contracts, there was no indication that they were fraudulent. It is unlikely, moreover, that minimal investigation would have revealed that these contracts had been signed as an accommodation. Under the circumstances, we cannot say that the bankruptcy court erred in finding that BancBoston acted

reasonably in relying on the contracts. Section 523(a)(2)(A) does not ordinarily require lenders to assume that commercial borrowers who have been credible in the past will not continue to be credible. Assuming that a reasonableness requirement still exists after *Grogan v. Garner,* the requirement merely prevents creditors from looking the other way in the face of facts that ought to raise suspicions.

This case does not resemble *In re Ward,* 857 F.2d 1082, where we held that a bank that issued a credit card to the debtor without first running a credit check on him was not entitled to have the credit card indebtedness declared nondischargeable under § 523(a)(2)(A). The debtor in *Ward,* who had no previous relationship with the credit card issuer, received a credit card application as part of a nationwide direct mailing. When he returned the application form, the bank approved a credit card for him without requesting a financial statement and without checking his credit history. A credit report would have shown that he owed money on at least twelve other accounts and that he had been ordered to make restitution of $250,000 following a conviction for embezzlement. The bank that issued the card contended that it had relied on (1) the debtor's false representation on his application that he was financially responsible and would pay the charges he incurred, and (2) his implied promise each time he used the card that he would pay the charges. We concluded that it was unreasonable as a matter of law to rely on such representations without conducting the "minimal investigation and verification" that "almost certainly would have uncovered the falsity of the representations." *Id.* at 1084. Our conclusion was strengthened by

the fact that the credit card indebtedness was incurred for personal use, not commercial use, and by the fact that congressional committee reports suggested that consumer finance companies should use readily available independent sources of information (credit bureau reports, *e.g.*) to verify a consumer borrower's creditworthiness. H.R.Rep. No. 595, 95th Cong., 2d Sess. 130 (1977), reprinted in [1978] U.S.Code Cong. & Admin.News 5963, 6091.

In the instant case, of course, the loan was made to a sophisticated borrower for commercial purposes. As was not true in *Ward*, the lender had a prior business relationship with the borrower. There is no reason to believe, moreover, that minimal investigation by BancBoston would have revealed that two of the purchase contracts on which the bank relied had been signed as an accommodation by people who had no intention of performing. It would not be so unreasonable for a lender in BancBoston's position to rely on the contracts as to make it unlikely that reliance actually occurred.

* * *

We turn now to the issue peculiar to Dr. Sikes. It is undisputed that under Tennessee agency law Dr. Sikes is liable, regardless of his own culpability, for the full amount of the partnership's debt to BancBoston. It is also undisputed that Dr. Sikes' liability under state law gives BancBoston a valid claim against his estate for the full amount of the partnership's debt. It is less clear, however, whether federal bankruptcy law requires some culpability on the part of Dr. Sikes if BancBoston's claim against him is to be held nondischargeable in bankruptcy. Dr. Sikes contends that even if the bank's reliance on the

misrepresentations was reasonable, the debt should be deemed dischargeable as to him as long as he did not know of the fraud. This argument raises a question of first impression in our circuit: whether, for purposes of § 523(a)(2)(A), the fraud of one partner can be imputed to another partner who had no actual knowledge of it.

The Court of Appeals for the Fifth Circuit had occasion to address this question recently in *In re Luce*, 960 F.2d 1277 (5th Cir.1992). There a husband and wife, Mr. and Mrs. Luce, were partners in several partnerships that obtained loans from finance companies through fraud perpetrated by Mr. Luce. After bankruptcy was declared, the finance companies challenged the dischargeability of the partnership's debt insofar as both of the Luces were concerned. The bankruptcy court found the debts non-dischargeable as to both, and the district court affirmed. On appeal to the Fifth Circuit, Mrs. Luce argued that the debt should be held dischargeable as to her because she had no knowledge of the fraud perpetrated by her husband.

Citing with approval the district court's opinion in the instant case, the court of appeals upheld the bankruptcy court's conclusion that knowledge of the fraud should be imputed to Mrs. Luce. The court said that the Luces' marital relationship was not relevant to its decision, and based its holding on the facts that (1) Mrs. Luce was a partner, (2) Mr. Luce made the misrepresentations while acting on behalf of the partnerships in the ordinary course of business, and (3) as a partner, Mrs. Luce shared in the monetary benefits of the fraud.

The Fifth Circuit's analysis, which we find persuasive, is directly applicable here. Like Mr. Luce, Mr. Ledford perpetrated his fraud while acting on behalf of the partnership in the ordinary course of the partnership's business. Like Mrs. Luce, Dr. Sikes shared in the monetary benefits of the fraud. Mr. Ledford did not divert the proceeds of the construction loan to his personal use. The funds were used for partnership purposes; they financed a condominium project from which Dr. Sikes stood to profit.

The result we reach in this case is consistent with the decisional law that existed before enactment of the Bankruptcy Code. See *Strang v. Bradner,* 114 U.S. 555, 561, 5 S.Ct. 1038, 1041, 29 L.Ed. 248 (1885). There the Supreme Court, speaking through the elder Justice Harlan, held that for purposes of determining dischargeability of indebtedness, one partner's fraud may be imputed to other partners who had no knowledge of it. The fraud in *Strang* was perpetrated within the scope of the partnership's business, and, as in the case at bar, the innocent partners received the fruits of the fraudulent conduct.

For the reasons stated, and because we do not find any of the debtors' remaining arguments persuasive, the judgment of the district court is AFFIRMED.

Nos. 91-5594/5649

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

IN RE: THOMAS E. LEDFORD; J. GREGG SIKES, Debtors, --- BANCBOSTON MORTGAGE CORPORATION, Plaintiff-Appellee, v. THOMAS E. LEDFORD, Defendant (91-5594), Defendant-Appellant (91-5649), J. GREGG SIKES, Defendant-Appellant (91-5594), Defendant (91-5649).	**ORDER** (Filed Sept. 17, 1992)

BEFORE: KEITH and NELSON, Circuit Judges; and TIMBERS,* Senior United States Circuit Judge.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc,

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* Hon. William H. Timbers sitting by designation from the United States Court of Appeals for the Second Circuit.

the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER
OF THE COURT

/s/ Leonard Green, Clerk
Leonard Green, Clerk

BANCBOSTON MORTGAGE CORPORATION

v.

Thomas E. LEDFORD, et al.

In re Thomas E. LEDFORD, Debtor, J. Gregg Sikes, Debtor.

BANCBOSTON MORTGAGE CORPORATION

v.

Thomas E. LEDFORD, et al.

Nos. 3:90-0661, 3:90-0873.

United States District Court,
M.D. Tennessee,
Nashville Division

April 26, 1991.

D. Reed Houk, Paul S. Davidson, Stokes & Bartholomew, Nashville, Tenn., for Bancboston Mortg. Corp.

William Caldwell Hancock, Nashville, Tenn., for Ledford.

Paul E. Jennings, Nashville, Tenn., for Sikes.

MEMORANDUM

WISEMAN, Chief Judge.

These two cases, consolidated in the bankruptcy court below, arose from the failure of a condominium development in Nashville, Tennessee, and the subsequent personal bankruptcy filings of the two partners in the development. The bank that financed the development, alleging that it had disbursed the loan proceeds because

of fraud, sought to have the partners' debt to it declared nondischargeable under 11 U.S.C. § 523(a)(2)(A). The bankruptcy court held that defendant Thomas E. Ledford's debt was nondischargeable but that defendant J. Gregg Sikes' debt was dischargeable. Both Ledford and the bank have appealed the bankruptcy court decision. For the following reasons, the Court affirms in part and reverses in part.

I.

Thomas E. Ledford ("Ledford") and J. Gregg Sikes ("Sikes") were general partners in Montclair, Ltd. ("Montclair"), a Tennessee limited partnership. Ledford was also the president and sole stockholder in Ledford Properties, Inc., the developer retained by Montclair. Montclair's object was to develop a condominium complex on West End Avenue in Nashville.

In April, 1986, Ledford obtained a loan from BancBoston Mortgage Corporation ("BBMC") of $1,600,000.00 to acquire land on which the condominiums would be built. The parties amended the loan agreement in October 1986 to increase the principal to $6,225,000.00 to provide funds for construction of the project.

Under the terms of the agreements, Montclair was required to obtain twenty contracts for sale of condominium units before BBMC would disburse the loan funds. In September 1986, this was reduced to fourteen contracts. The contracts had to be legally enforceable with bona fide third-party purchasers and entered into upon forms provided by BBMC. In addition, the contracts were not to be amended without BBMC's written consent, and they had

to comply with certain minimum sales price and earnest money deposit requirements.

By November 1986, Montclair had presented to BBMC the required fourteen contracts, which, on their face, complied with all conditions of the loan agreement. Despite their apparent compliance, seven of these contracts contained contingencies added by addendum or verbal side agreements which were not disclosed to BBMC.

As a result of this fraud and misrepresentation, BBMC disbursed the construction loan funds in December 1986. While the project was substantially completed by October 1987, only one of the fourteen contracts had closed by December of that same year. Montclair defaulted on the terms of the loan in January 1988. BBMC learned of the misrepresentations while attempting to close the other contracts, and in May 1988, instituted an action against Ledford and Sikes on their personal guaranties of the loan. United States District Court Judge Higgins entered a judgment against the partners in January 1989. *Bancboston Mortgage Corporation v. Ledford*, No. 3:88-0429 (M.D.Tenn. Jan. 3, 1989).

Ledford filed for personal bankruptcy in December 1988, and Sikes filed for personal bankruptcy on January 30, 1989.

The bankruptcy court held that Ledford's debt to BBMC on the guaranty was nondischargeable under 11 U.S.C. § 523(a)(2)(A). The court found that: Ledford made material misrepresentations to BBMC; Ledford knew that the contracts did not comply with the terms of the loan agreement; Ledford made the representations with the

intent to deceive BBMC; BBMC reasonably relied on the misrepresentations; and the misrepresentation caused BBMC's actual damages.

By contrast, the bankruptcy court held that Sikes' debt to BBMC on his guaranty was dischargeable. The court reasoned that there was insufficient evidence to prove clearly and convincingly that Sikes participated in, or had knowledge of his partner's actions, and that the fraud could not be imputed to Sikes as a matter of law.

Ledford appealed to this court the non-dischargeability of his debt to BBMC. BBMC appealed the bankruptcy court's discharge of Sikes' debt.

These cases present two issues for this court to decide: First, whether the bankruptcy court erred in finding that BBMC reasonably relied on Ledford's misrepresentations; and second, whether the bankruptcy court erred in holding that Ledford's fraud could not be imputed to Sikes for the purpose of determining the dischargeability of Sikes' debt to BBMC.[1]

II.

Under Bankruptcy Rule 8013, the district court is directed that "findings of fact shall not be set aside unless

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[1] Ledford also argues on appeal that the bankruptcy court erred in applying a "but for" test of proximate cause and also that it erred in granting any judgment to BBMC given its finding that BBMC's proof of damages was not precise, and in failing to adjudicate the amount of damages. This Court finds both of these arguments without merit and affirms the bankruptcy court's opinion in both respects.

clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of witnesses." The Advisory Committee Note makes clear that the rule accords to the findings of a bankruptcy judge the same weight given the findings of a district judge under Fed.R.Civ.P. 52. *See Boone Coal and Timber Co. v. Polan*, 787 F.2d 1056, 1062 n.4 (6th Cir.1986). Consequently, the district court must review the bankruptcy judge's legal conclusions de novo, not according any presumptions to the bankruptcy court's interpretation of applicable law. *Id* at 1062; *In re Spain*, 103 B.R. 286, 289 (N.D.Ala.1988). *See also In re Daniels-Head & Associates*, 819 F.2d 914, 918 (9th Cir.1987)("The district court acts as an appellate court, reviewing the bankruptcy court's findings of fact under the clearly erroneous standard and its conclusions of law de novo."); *In re Martin*, 761 F.2d 1163, 1165 (6th Cir. 1985).

III.

Debts obtained by fraud are not dischargeable in bankruptcy. Section 523 of the Bankruptcy Code provides in pertinent part:

> (a) A discharge . . . does not discharge an individual debtor from any debt– . . .
>
> > (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by–
> >
> > > (A) false pretenses, a false representation, or actual fraud, other than a statement

> representing the debtor's or an insider's financial condition; . . .

11 U.S.C. § 523(a)(2)(A). Both issues in this case turn on the interpretation of this provision. It is well established that the fraud exception to dischargeability includes a requirement that the lender's reliance on the debtor's misrepresentations be reasonable. *In re Phillips*, 804 F.2d 930, 932 (6th Cir.1986); *In re Kimzey*, 761 F.2d 421, 423 (7th Cir.1985). Ledford's appeal is based primarily on the interpretation of this requirement of reasonable reliance. In Sikes' case, BBMC's appeal turns on whether the fraud specified in § 523(a)(2)(A) can be imputed to Sikes from his partner, Ledford.

A. *Reasonable Reliance*

The seminal case in the Sixth Circuit on reasonable reliance is *Phillips*. *Phillips* involved a mortgagee of a farm who failed to conduct a title search because of a personal relationship with the mortgagor. The mortgagee sought to have the debt declared nondischargeable because the mortgagor had misrepresented the size of the property. The court held that cases involving reliance in a commercial setting were inapposite to this situation, and that the reliance was reasonable.

In *Phillips*, the court considered three approaches to interpreting the reasonable reliance requirement of 11 U.S.C. § 523(a)(2)(A):

(1) Reasonable reliance is not required. *In re Sobel*, 37 B.R. 780, 785-86 (Bankr.E.D.N.Y.1984); *In re Fosco*, 14 B.R. 918, 921-23 (Bankr.D.Conn.1981).

(2) Reasonable reliance is required because the bankruptcy policy of providing debtors with a "fresh start" outweighs the rights of creditors who rely unreasonably. *In re Newmark*, 20 B.R. 842, 861-62 (Bankr.E.D.N.Y.1982).

(3) Reasonable reliance is circumstantial evidence of actual reliance. *In re Garman*, 643 F.2d 1252, 1256 (7th Cir.1980), *cert denied*, 450 U.S. 910, 101 S.Ct. 1347, 67 L.Ed.2d 333 (1981).

804 F.2d at 932-33. The Sixth Circuit, which had previously adopted the reasoning of *Garman* with respect to § 523(a)(2)(B) cases (involving fraudulent financial statements), *see Martin*, 761 F.2d 1163, adopted it for § 523 (a)(2)(A) cases as well. 804 F.2d at 933.

The Sixth Circuit held that the critical concern is to accord " 'a construction of the [Bankruptcy Code that] is consonant with equity, and consistent with the object and intention of Congress in enacting a general law by which the *honest* citizen may be relieved from the burden of hopeless insolvency.' " *Phillips*, 804 F.2d at 933 (citing *Neal v. Clark*, 95 U.S. (5 Otto) 704, 709, 24 L.Ed. 586 (1877) (emphasis in original)).

The reasonable reliance requirement balances the recklessness of the lender with the culpability of the debtor who has defrauded him. *Phillips* relied on *Martin* to reach the conclusion that "the reasonableness requirement was intended to incorporate prior case law into the current Bankruptcy Act. . . . As such, it cannot be said to be a rigorous requirement, but rather is directed at creditors acting in bad faith." 804 F.2d at 933 (citing *Martin*,

761 F.2d at 1163). The *Martin* court had observed that Congress was concerned that creditors use, when feasible, other data sources, such as credit bureau reports, to determine the accuracy of the debt list. 761 F.2d at 1166. Such a determination requires consideration of all facts and circumstances, including the size of the loan.

Following *Garman*, several courts have described its standard almost as a recklessness test: reliance would be reasonable provided the representation relied upon appeared sufficient and accurate. *See Knoxville Teacher's Credit Union v. Parkey*, 790 F.2d 490, 492 (6th Cir.1986); *In re Sanders*, 110 B.R. 328, 330-31 (Bankr.M.D.Tenn.1989); *In re Constantino*, 72 B.R. 231, 235 (Bankr.N.D.Ohio 1987); *In re Winfree*, 34 B.R. 879, 885 (Bankr.M.D.Tenn.1983); *cf. In re Weiner*, 86 B.R. 912, 915 (Bankr.N.D.Ohio 1988) ("facially erroneous" financial statement contained errors so gross as to negate actual reliance).

The *Garman* standard incorporates deference to the business judgment of the creditors. The critical issue is whether reliance on the representations was reasonable, not whether the decision to loan money was reasonable. Care must be taken to avoid scrutinizing the creditor's business judgment instead of determining whether reliance was reasonable. *Garman*, 643 F.2d at 1258; *In re Hall*, 109 B.R. 149, 154-55 (Bankr.W.D.Penn.1990); *In re Kroh*, 88 B.R. 987, 995 (Bankr.W.D.Mo.1988).

Ledford relies on *In re Ward*, 857 F.2d 1082 (6th Cir.1988) to support his argument that his debt should be dischargeable. *Ward* involved a debtor to whom a bank issued a credit card without any inquiry, which would

have revealed a recent embezzlement and hopeless insolvency. The court held that the bank's reliance on the debtor's false representations was unreasonable, and that it had a duty to conduct a credit check prior to issuing the card. According to the Sixth Circuit, the bank had assumed the risk of non-payment: "This court rejects extending preferential protection at the expense of other unsecured creditors, to credit card companies which profit from extending consumer credit at the risk of non-payment, which risk is factored into finance charges which are higher than the rates charged by other lenders." 857 F.2d at 1085

The *Ward* court's normative and deterrent desires, and its concern with the bank's behavior, apparently led it to declare general requirements for lenders. In this respect, it is similar to the Tenth Circuit's decision in *In re Mullet*, 817 F.2d 677 (10th Cir.1987), in which a bank loaned $86,000 to a 23-year old who owned stock which he claimed was traded on the New York Stock Exchange, but which actually was the stock of a company with a similar name. Noting that "minimal investigation and verification almost certainly would have uncovered the falsity of the representation," *id.* at 680, the court held that the bank's reliance was unreasonable. Both *Ward* and *Mullet* are egregious cases, which may justify a departure from the *Phillips* standard to one which asks whether the lender's decision to loan had any justification.

Ward clearly is distinguishable from this case. First, in *Ward*, there was no prior relationship between the borrower and the lender. In this case, Ledford had borrowed money from BBMC for the successful development of a prior project, the Park Circle condominiums, without

misrepresentation. Such prior dealings have been a significant factor in other cases. In *Phillips*, for example, the friendship between the mortgagee and mortgagor was paramount. The court ruled that commercial lending cases were inapposite where there is such a relationship. *Phillips*, 804 F.2d at 933. *See also Martin*, 761 F.2d at 1166-67; *Garman*, 643 F.2d at 1257; *In re Lambert*, 64 B.R. 170, 177 (Bankr.E.D.Tenn.1986).

Second, this case, unlike *Ward*, involves a sophisticated borrower dealing at arm's length with the lender. Where the debtor is an unsophisticated consumer, as in *Ward*, one can argue that lenders have a greater responsibility to determine credit-worthiness. Indeed, many consumers may be unable to determine without assistance the amount of debt they can carry safely. Ledford, however, possesses a master's degree in public administration and is an experienced real estate developer. *See* Memorandum of Bankruptcy Court ("Memorandum"), June 22, 1990, at 21.

In short, there is nothing in *Ward* to mandate a departure from the standard the Sixth Circuit announced in *Phillips*: that reliance is reasonable provided the representation relied upon appears sufficient and accurate. The question in the instant case is whether the contracts satisfy this requirement, and whether there were "red flags" – facts which should have put BBMC on notice. In answering these questions, the Court reiterates that the requirement of reasonable reliance is "directed at creditors acting in bad faith." *Martin*, 761 F.2d at 1166. *See also Garman*, 643 F.2d at 1256. Moreover, the sufficiency of the contracts must be interpreted in light of the purpose for which they were required: to prove substantial market

interest in the condominium units. This purpose does not necessitate the same scrutiny as would a personal financial statement. As the bankruptcy court found, BBMC checked each contract for the required elements, and rejected a contract which contained contingencies. Memorandum at 22.

In this case, Ledford argues that sufficient indicia of unreliability existed to have warned BBMC that the contracts were not reliable. Ledford argues that four "red flags" put BBMC on notice about problems with the contracts. These include:

(1) Handwriting on Sands and Tant contracts. Two of the contracts contained handwriting indicating that the buyers reserved the ability to sell their contracts. But since nothing indicated to BBMC that the purchasers of these contracts would not be bound, or that the original buyers (Sands and Tant) would be released by any contingency other than finding another buyer, these contracts did not put BBMC on notice that the contracts were anything other than bona fide. This contention is without merit.

(2) Layman contract. The most substantial issue Ledford raises is that one contract contained handwriting indicating the incorporation of an attached addendum which was not submitted to BBMC. The fact that the described addendum was never submitted should have raised suspicions. The bankruptcy court found, however, that BBMC's manager never saw the note – an oversight on his part. Memorandum, at 18. This is a finding of fact, subject to a clearly erroneous standard of review under

Bankr.R. 8013 and nothing in the Memorandum of decision or the briefs of the parties indicates that the bankruptcy judge's finding was erroneous.

(3) Reduction in number of pre-sale contracts. The loan agreement initially required twenty pre-sale contracts. The parties subsequently agreed to reduce this requirement to fourteen contracts. This issue demonstrates the shadowy line between assessing the reasonableness of reliance and second-guessing the creditor's decision to lend. Certainly, Ledford's request to reduce the number of contracts indicated a softer market for the units; however, it cannot be said to reasonably raise the suspicion that he would be fabricating contracts.

(4) Required delivery dates in some contracts did not meet builder's completion dates. As the bankruptcy judge noted, this problem "does not take away from the fact that if these were bona fide contracts they would have shown the existence of a market and the acceptance of the developer." *See* Memorandum at 23. The significance of this deviation must be interpreted in light of the contracts' purpose in the loan agreement. The contracts were needed simply to indicate market interest at the commencement of the project. As the bankruptcy court noted, "if these were bona fide contracts they would have shown the existence of a market and the acceptance of the developer." Memorandum at 23. The purchasers' acceptance of the contract therefore served its purpose vis-a-vis the loan agreement regardless of the problem with the dates.

Ledford's "red flags" are, as the brief for BBMC indicates, really "red herrings." Brief for Appellee at 17.

There is no evidence to indicate that BBMC had knowledge of facts which should have put it on notice that its reliance on the contracts for the purpose they were to serve – to indicate market interest – was unreasonable or illusory. Neither the facts nor the law justify reversal. As a result, the bankruptcy court's holding that Ledford's debt to BBMC is not dischargeable under 11 U.S.C. § 523(a)(2)(A) is affirmed.

B. *Imputed Fraud*

The courts are split on whether the fraud of one partner may be imputed to another in determining the dischargeability of a debt under 11 U.S.C. § 523(a)(2)(A). As the bankruptcy court noted, "[s]ome courts have held that the fraud of an authorized agent, without more, is grounds for nondischargeability of the principal. . . . " Memorandum of Bankruptcy Court, Sept. 12, 1990, at 3. Other courts, however, refuse to impute the fraud for purposes of determining dischargeability, without proof of knowledge or intent. The bankruptcy court expressly rejected imputation of fraud for the purpose of determining dischargeability without such proof. The Sixth Circuit has not addressed this issue.

The bankruptcy court's decision is supported by a short and troubled line of cases. Four arguments emerge in these cases to support the proposition that a debt obtained by fraud is dischargeable as to an innocent partner:

(1) Changes made in enacting the Bankruptcy Code require intent to deceive on the part of each partner held liable;

(2) Precedent under the Bankruptcy Act and Code establishes a requirement of actual or constructive knowledge to impute fraud;

(3) *Neal v. Clark*, 95 U.S. (5 Otto) 704, 24 L.Ed. 586 (1887), establishes that fraud may not be imputed to an innocent partner; and

(4) The structure of § 523 of the Bankruptcy Code evinces a requirement of wrongful conduct by the debtor himself.

Each of these arguments is considered in turn below. The Court finds that each is without merit.

First, Sikes maintains that changes made in the enactment of the Bankruptcy Code indicate that fraud should be imputed to a debtor only when that debtor knew of the partner's fraud. In *Matter of Gray*, 22 B.R. 676 (Bankr.W.D.Wis.1982), the bankruptcy court cited an alleged change in law upon the enactment of the Code as the basis for its decision not to impute fraud to an ignorant partner for purposes of determining dischargeability. In *Gray*, a father and son were partners in a construction business. The son submitted a false financial statement to a supplier in order to secure credit, and the supplier sought to have the debt declared nondischargeable when the father subsequently declared bankruptcy. In response to the supplier's motion for summary judgment, the bankruptcy court held that § 523(a)(2)(A) required knowledge and intent, and the existence of these issues of fact precluded summary judgment. The court reviewed the pre-Code cases interpreting the predecessor to § 523, and held them to be inapposite, because of the addition of language requiring intent to deceive. *Id.* at 680.

But the bankruptcy court in *Matter of Walker*, 53 B.R. 174 (Bankr.W.D.Mo.1985) ("*Walker II*") demonstrated that in fact there had been no change in the law through the addition of the language to § 523. Section 523(a)(2) is derived from § 17(a)(2) of the former Bankruptcy Act, 11 U.S.C. § 35 (repealed 1978). The *Walker II* court's specific criticism of *Gray* is that it interpreted the Code's dischargeability provision, 11 U.S.C. § 523(a)(2), as being closely related to the Act's discharge provision. *Id.* at 180. This court agrees with *Walker II* that *Gray* erred in claiming that the Code added intent to deceive language, thereby barring imputation of fraud to an ignorant partner. In fact, the Act contained a nearly identical requirement. A comparison reveals that § 523(a)(2)(B)(iv) of the Code renders nondischargeable debts "that the debtor caused to be made or published *with intent to deceive*," (emphasis added) while § 17(a)(2) of the Act applies to those debts that the debtor "made or published or caused to be made or published in any manner whatsoever *with intent to deceive* (emphasis added)."

Moreover, the legislative history of § 523(a)(2) does not reveal substantive changes that would justify a reversal of precedent under the Act. *See In re Paolino*, 75 B.R. 641, 647 (Bankr.E.D.Penn.1987). The Code added a section rendering nondischargeable debts obtained with false financial statements, 11 U.S.C. § 523(a)(2)(B), and added the words "actual fraud" to the general fraud exception to discharge. *Id.* at 646. But the latter change merely reflects the adoption of prior case law, including *Neal*, 95 U.S. (5 Otto) 704, which, as discussed *infra*, did not invalidate fraud imputed to an innocent partner. *Id. See also* 124

Cong.Rec. H11,095 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards).

Second, the Bankruptcy Court relies on two cases which claim that prior case law justifies discharge of an innocent partner's debt: *In re Anderson,* 29 B.R. 184 (Bankr.N.D.Iowa 1983), and *Matter of Walker,* 726 F.2d 452 (8th Cir.1984) ("*Walker I*"). Upon examination, the Court finds that neither of these cases is persuasive.

In *Anderson,* a partner in a tire store submitted false financial statements to obtain credit. The "innocent" partner discovered the misrepresentation when the "guilty" partner had a nervous breakdown. The court followed *Gray,* and held that it would not impute one partner's intent to deceive to the other innocent partner. *Id.* at 191. In arriving at this conclusion, the court held that "[t]he clear legislative policy of discharging the honest debtor would be negated by imputing the deceptive intent of one partner to an honest, innocent debtor partner." *Id.*

In *Walker I,* the debtor and his wife ran a hardware store. The debtor became sick, and turned the business over to his wife, who assigned fictitious accounts receivable to a bank for loans. After discovering the fraud, the debtor filed for bankruptcy under Chapter 7. The bankruptcy court declared the debt nondischargeable, but the district court reversed, claiming that proof of the debtor's knowledge was necessary. The Eighth Circuit remanded the case, holding that the bankruptcy court's findings were insufficient to decide the case. It announced that, "[P]roof that a debtor's agent obtains money by fraud does not justify the denial of discharge to the debtor, unless it is accompanied by proof which demonstrates or

justifies an inference that the debtor knew or should have known of the fraud." *Id.* at 454. It also observed that reckless indifference would not justify discharge.

Both opinions were called into question in the opinion of the bankruptcy court of *Walker I* on remand – *Walker II*. The court criticized *Anderson* for an "avulsive departure from the law of nondischargeability upon a nonexistent set of authorities." 53 B.R. at 179-80. Moreover, the court rebuffed the Eighth Circuit's opinion in *Walker I*, claiming that its opinion on dischargeability was based upon authorities related only to the question of discharge. *Id.* at 180-81. *Walker I* also has been criticized by other courts that have addressed this issue. *See In Re Futscher*, 58 B.R. 14, 17 (Bankr.S.D.Ohio 1985); *Paolino*, 75 B.R. at 649. The bankruptcy court in *Walker II* nevertheless conducted an evidentiary hearing, and, concluding that the debtor should have known of his wife's misrepresentations, determined (again) that the debt was not dischargeable.

Walker II forcefully argues that the support for requiring a partner's actual or constructive knowledge is inadequate. The thrust of the bankruptcy court's argument in *Walker II* is that the handful of courts which have imposed this requirement have confused discharge with dischargeability, and that this confusion has arisen from the differences between the Bankruptcy Act and the Code with respect to discharge. Section 14(c) of the Act provided that a *discharge* (i.e. in its entirety) would be denied to debtors who had obtained property based on fraud. Section 14(c) provides in pertinent part that: "The Court shall grant the discharge unless satisfied that the bankrupt has . . . obtained for such business money or

property . . . by making or publishing or causing to be made . . . a materially false [financial] statement. . . . " By contrast, Section 17 held that *specific debts* so obtained were nondischargeable. The bar to discharge was dropped when the Code was enacted. Section 17 provides in pertinent part that: "A discharge in bankruptcy shall release a bankruptcy from all of his provable debts . . . except such as . . . are liabilities for obtaining money or property by . . . a materially false [financial] statement. . . . " Under the Code, fraud or misrepresentation does not bar a discharge itself, but continues to render the debt so obtained nondischargeable. 11 U.S.C. § 523(a)(2).

The courts interpreting the Act held that fraud would not be imputed to bar discharge itself, but would be imputed to bar dischargeability of the specific debt. *See Walker I*, 726 F.2d at 177; *Paolino*, 75 B.R. at 647. It is easy to confuse these issues, and some courts (including those in *Anderson* and *Walker I*) relied on the discharge cases to justify their dischargeability holdings. *See Walker II*, 53 B.R. at 180-81 ("Each of the authorities thus alluded to by the court of appeals was exclusively a denial of discharge case."). Again, this court agrees with *Walker II* that the better reasoned case law supports imputation of fraud without knowledge.

Third, Sikes argues that the bankruptcy court opinion is supported by Supreme Court precedent. But it is a misuse of authorities to rely on *Neal*, 95 U.S. (5 Otto) 704, for the proposition that fraud cannot by imputed to an innocent partner. *Paolino*, 75 B.R. at 648.

In *Neal*, an executor sold some property of a decedent for some bonds. The executor then sold the bonds to Neal, who passed them on to another. The heirs later sued the executor for an accounting, and joined Neal as a defendant, claiming that, under the circumstances, Neal had participated in a wasting of the estate. Neal later declared bankruptcy, and the heirs sought to have the debt declared nondischargeble, because the fraud should be imputed to Neal. The Supreme Court of Virginia declared that, though Neal was innocent of actual fraud, he was nonetheless guilty of constructive fraud, and that the Bankruptcy Act's definition of fraud embraced both kinds. On appeal, the United States Supreme Court reversed, holding that:

> 'fraud' referred to in that section means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement; and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality. Such a construction of the statute is consonant with equity, and consistent with the object and intention of Congress in enacting a general law by which the honest citizen may be relieved from the burden of hopeless insolvency.

95 U.S. at 709.

The bankruptcy court in *In re Buck*, 75 B.R. 417 (Bankr.N.D.Cal.1987), relied on *Neal* in holding that actual fraud could only be imputed where the partner was a knowing and active participant in the scheme to deceive. But the *Buck* court's interpretation of *Neal* does not consider that the Supreme Court had itself refused to extend *Neal* in *Strang v. Bradner*, 114 U.S. 555, 5 S.Ct. 1038,

29 L.Ed. 248 (1855). *See Paolino*, 75 B.R. at 648. *Strang* involved a situation similar to that at hand: one partner defrauded creditors without the other partners' knowledge. Justice Harlan, writing for the unanimous Court as he had in *Neal*, based the decision holding the debt nondischargeable on agency law:

> Whether this action be regarded as one to recover damages for the deceit practiced upon the plaintiffs, or as one to recover the amount of a debt created by fraud upon the part of Strang, we are of opinion that his fraud is to be imputed, for the purposes of this action, to all members of his firm. . . . Each partner was the agent and representative of the firm with reference to all business within the scope of the partnership. And if, in the conduct of partnership business and with reference thereto, one partner makes false or fraudulent misrepresentations of fact to the injury of innocent persons who deal with him as representing the firm, and without notice of any limitations upon his general authority, his partners cannot escape the pecuniary responsibility therefore upon the ground that such misrepresentations were made without their knowledge. This is especially so when, as in the case before us, the partners, who were not themselves guilty of wrong, received and appropriated the fruits of the fraudulent conduct of their associate in business.

Strang, 114 U.S. at 561, 5 S.Ct. at 1041. Thus, the Supreme Court explicitly refused to apply *Neal* as the *Buck* court suggested should be done. *Id.*

Finally, at least one bankruptcy court has based its refusal to impute liability to an innocent partner on a

structural analysis of § 523. *In re Futscher,* 58 B.R. 14 (Bankr.S.D.Ohio 1985). In *Futscher,* the debtor was the ostensible owner of a Corvette repair shop, purchased by a disreputable friend who eventually left the city. The shop was managed by its previous owner, who defrauded a customer of money paid for parts which were never ordered. The bankruptcy court noted the dubious quality of the *Walker I* decision, but nevertheless adopted a similar position based on its analysis of § 523. 58 B.R. at 17. It reasoned that § 523 exceptions from discharge can be divided into those which are based on policy consideration (e.g. student loans), and those which are based on the wrongful conduct of the debtor (e.g. fraud). It held that nondischargeability because of fraud was not a policy-based exception, and required some blameworthy conduct on the part of the debtor. In the case before it, the bankruptcy court held the debt to be nondischargeable because the ostensible owner had knowledge of the manager's dishonesty prior to the customer's payment.

The Court in *Futscher* divined its rule from the structure of § 523:

> If one examines the provisions of 11 U.S.C. § 523, it is apparent that two broad categories of debts are dealt with in the ten subdivisions of § 523(a). One broad category relates to public policy matters. Thus, at § 523(a)(1), taxes are made non-dischargeable; at § 523(a)(3), unlisted debts are made non-dischargeable; at § 523(a)(5), alimony, maintenance, and child support obligations are made non-dischargeable; at § 523(a)(7), a fine, penalty, or forfeiture to the government is made non-dischargeable;

> at § 523(a)(8), student loans are made non-dischargeable; at § 523(a)(9), drunk driving debts are made non-dischargeable; and at § 523(a)(10), debts surrounding a prior bankruptcy are made non-dischargebale.
>
> The other broad category may be characterized as debts which ought not to be dischargeable because they arose from wrongful acts. This category is comprised of those debts set forth at § 523(a)(2), debts due to false and fraudulent acts; and § 523(a)(4), debts due to fraud or defalcation of a fiduciary, embezzlement, or larceny; and § 523(a)(6), debts arising from willful or malicious injury. The distinction between these two broad categories suggests to us that it is only in the first category, those arising from public policy considerations, that a debt will be held to survive a discharge in bankruptcy in the absence of an intentional or wrongful act by the debtor.

Futscher, 58 B.R. at 17.

This is a novel reading of the Code, and it contradicts evidence that Congress did not intend to make major substantive changes in this area. *See Paolino*, 75 B.R. at 646. Moreover, it ignores the long line of cases imputing liability to an innocent partner, and the Supreme Court's admonition that changes in statutory interpretations must be supported by clear Congressional intent. *Kelly v. Robinson*, 479 U.S. 36, 47, 107 S.Ct. 353, 93 L.Ed.2d 216 (1986); *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection*, 474 U.S. 494, 501, 106 S.Ct. 755, 759, 88 L.Ed.2d 859 (1986).

The other sources cited by Sikes are similarly unpersuasive: each refers to a case involving the imputation of

fraud between spouses, and are decided without regard to agency law. *Cf. Paolino*, 75 B.R. at 648-50. They are inapposite to this case. With the exception of the cases discussed above – *Gray, Anderson, Walker I, Futscher*, and *Buck* – the authorities are in agreement that the fraud of one partner may be imputed to another for determining dischargeability under 11 U.S.C. § 523(a)(2). *See, e.g., In re Cecchini*, 780 F.2d 1440, 1444 (9th Cir.1986); *Paolino*, 75 B.R. at 649-50; *Walker II*, 53 B.R. at 181-82; *In re Beleau*, 35 B.R. 259, 262 (Bankr.D.R.I.1983); and *In re Lowther*, 32 B.R. 638, 641-42 (Bankr.W.D.Okla.1983).

It is equally clear that, under Tennessee state law, the fraud of one partner must be imputed to another. In *Griffin v. Bergeda*, 279 S.W. 385, 152 Tenn. 512 (1926), the Tennessee Supreme Court imputed fraud to a partner for purposes of determining dischargeability under the Bankruptcy Act. *See also George Busby Ford, Inc. v. Ross*, 62 Tenn.App. 80, 459 S.W.2d 46 (1970) (following *Griffin*). Imputed liability is also mandated by statute in Tennessee. Tennessee has adopted the Uniform Partnership Act, which provides:

> Wrongful acts of partners. – Where, by any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership, or with the authority of his copartners, loss of injury is caused to any person, not being a partner in the partnership, or any penalty is incurred, the partnership is liable therefore to the same extent as the partner so acting or omitting to act.

T.C.A. § 61-1-112 (1989). Under Tennessee state partnership law, Ledford's fraud should be imputed to Sikes regardless of the latter's ignorance of the fraud.

The imputation of fraud in this case not only coincides with well-settled law, it is also sound policy. As Ledford's general partner, Sikes had the opportunity and duty to ensure that the affairs of the partnership were conducted with integrity. He was in the best position to prevent the fraud, and to discover it before it damaged the partnership's creditors. By participating as a general partner, Sikes accepted these obligations. If he desired a lesser role in the management of the partnership, and more limited liability, he could have chosen either a limited partnership or a corporate form of business. Instead, he chose to participate as a general partner, and he must accept responsibility for the acts of his partner.

For the foregoing reasons, the decision of the bankruptcy court, holding that Sikes' debt to BBMC's is dischargeable, is reversed.

An appropriate order will be so entered.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

IN RE:	)	CASE NO.
THOMAS E. LEDFORD,	)	388-08502
J. GREGG SIKES,	)	CASE NO.
	)	389-00645
Debtors,	)	CHAPTER 7
BANCBOSTON MORTGAGE CORPORATION,	)	JUDGE KEITH M. LUNDIN
	)	
Plaintiff,	)	ADV. NO. 389-0154
v.	)	AND NO. 389-0155
	)	(CONSOLIDATED)
THOMAS E. LEDFORD and J. GREGG SIKES,	)	
	)	
Defendants.	)	
	)	

ORDER AND JUDGMENT OF DISMISSAL

(Filed Sept. 14, 1990)

Upon the motion of the debtor-defendant, J. Gregg Sikes ("Sikes"), made at the close of the plaintiff's proof and for reasons more fully stated in the Memorandum filed contemporaneously herewith, it is hereby

ORDERED, ADJUDGED and DECREED that the above-captioned adversary proceeding regarding Sikes shall be and hereby is dismissed with prejudice. Each party to said adversary proceeding shall bear their own costs and expenses of litigation.

ENTERED this 12 day of September, 1990.

/s/ Keith M. Lundin
KEITH M. LUNDIN
UNITED STATES
BANKRUPTCY JUDGE

CERTIFICATE OF SERVICE

I hereby certify that true and correct copies of the foregoing proposed Order and Judgment of Dismissal and Memorandum have been served upon Paul E. Jennings, 303 Church Street, Suite 101, Nashville, Tennessee 37201, and Wm. Caldwell Hancock, The Pilcher Building, Suite 300, 144 Second Avenue, North, Nashville, Tennessee 37201, by delivering same by hand, this 7th day of September, 1990.

/s/ Paul S. Davidson
Paul S. Davidson

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

IN RE:	)	CASE NO.
THOMAS E. LEDFORD,	)	388-08502
J. GREGG SIKES,	)	CASE NO.
	)	389-00645
Debtors,	)	CHAPTER 7
BANCBOSTON MORTGAGE	)	JUDGE KEITH M.
CORPORATION,	)	LUNDIN
	)	
Plaintiff,	)	ADV. NO. 389-0154
	)	AND NO. 389-0155
v.	)	(CONSOLIDATED)
THOMAS E. LEDFORD and	)	
J. GREGG SIKES,	)	
	)	
Defendants.	)	
	)	

MEMORANDUM
(Filed Sept. 7, 1990)

In these consolidated adversary proceedings, Plaintiff, BancBoston Mortgage Corporation ("BancBoston"), seeks a determination of the dischargeability of the debts of Defendants, Thomas E. Ledford ("Ledford") and J. Gregg Sikes ("Sikes") to BancBoston under 11 U.S.C. Section 523(a)(2)(A). This is a core proceeding under 28 U.S.C. Section 157(b)(2)(I). The following constitutes findings of fact and conclusions of law under Bankruptcy Rule 7052.

This Court has previously made findings of fact and conclusions of law with respect to BancBoston's claim against Ledford in a Memorandum entered June 22, 1990, and those findings are incorporated herein by reference.

For the reasons fully discussed in that Memorandum, the Court found that the evidence presented was clear and convincing that by false pretenses and misrepresentations Ledford obtained construction loan proceeds from BancBoston, and the Court found for BancBoston against Ledford under Section 523(a)(2)(A) of the Bankruptcy Code.

The issues presented with respect to Sikes are:

1. Whether the debt of Sikes to BancBoston is nondischargable under 11 U.S.C. Section 523(a)(2)(A);

2. Whether the false pretenses, false representations and/or actual fraud on the part of Ledford may be imputed to Sikes for purposes of determining dischargeability of his debt to BancBoston under 11 U.S.C. Section 523(a)(2)(A); and

3. Whether concepts of vicarious or imputed liability can support a claim for nondischargeabilty under 11 U.S.C. Section 523(a)(2)(A).

At all times relevant to this action, Sikes and Ledford were the sole general partners of Montclair, Ltd. ("Montclair"), a Tennessee limited partnership; and Ledford was Sikes' authorized agent with respect to the conduct of the business and affairs of Montclair.

At the close of BancBoston's proof at trial, the Court dismissed the claims against Sikes. Although BankBoston's proof established that Sikes was a co-general partner of Montclair, Ltd. with Ledford, and had made Ledford his agent with respect to the day-to-day decision making regarding the partnership's business, BancBoston's proof did not establish clearly and convincingly either that Sikes knew or should have known of Ledford's

fraud against BancBoston, or that Sikes had an intent to defraud or deceive BancBoston. Based on these findings, the sole remaining issue is whether concepts of vicarious or imputed liability can support a claim against Sikes for nondischargeability under Bankruptcy Code Section 523(a)(2)(A).

Some Courts have held that the fraud of an authorized agent, without more, is grounds for nondischargeability of the principal under 11 U.S.C. Section 523(a)(2). *See, e.g., In re Cecchini,* 780 F.2d 1440 (9th Cir 1986); *In re Powell,* 95 Bankr. 236, 240 (Bankr. S.D. Fla. 1989); *In re Hosking,* 89 Bankr. 971, 976-77 (Bankr. S.D. Fla. 1988); *In re Paolino,* 89 Bankr. 453 (Bankr. E.D. Ark. 1988); *In re Landsford,* 822 F.2d 901 (9th Cir. 1987); *In re Paolino,* 75 Bankr. 641 (Bankr. E.D. Pa. 1987); *In re Kay,* 60 Bankr. 174 (Bankr. C.D. Cal. 1986); *In re Walker,* 53 Bankr. 174, 179 (Bankr. W.D. Mo. 1985); *In re Beleau,* 35 Bankr. 259 (Bankr. D.R.I. 1983); *In re Lowther,* 32 Bankr. 638 (Bankr. W.D. Okla. 1983); *In re Shelton,* 28 Bankr. 218 (Bankr. E.D. Mo. 1983); *In re Warren,* 7 Bankr. 571, 573 (Bankr. N.D. Ala. 1980) (citing *Griffin v. Bergeda,* 152 Tenn. 512, 279 S.W. 385 (1926)); *In re Petitt,* 17 Bankr. 6 (Bankr. E.D. Ark. 1980); *see also* 3 *Collier* ¶ 523.08 at 523-52 (15th ed.).

This Court, however, expressly rejects the doctrine that the fraud of an agent, without clear and convincing proof of his knowledge or intent, may be imputed to the principal under section 523(a)(2). Instead, this Court follows those cases that have held that the fraud will be imputed to the debtor-principal only when the principal either knew or should have known of the agent's fraud. *See, e.g., Matter of Walker,* 726 F.2d 452 (8th Cir. 1984); *In re*

Futscher, 58 Bankr. 14 (Bankr. S.D. Ohio 1985); *In re Anderson*, 29 B.R. 184 (Bankr. N.D. Iowa 1983). *See also, In re Buck*, 75 Bankr. 417 (Bankr. N.D. Cal. 1987).

As stated in *Anderson* at 191, one of the primary purposes of the Bankruptcy Code is to relieve the honest debtor from the oppressive burden of his or her debts. In this Court's opinion, "[t]he clear legislative policy of discharging the honest debtor would be negated by imputing the deceptive intent of one partner to an innocent debtor partner." *Id.* For these reasons, the BancBoston proceeding against Sikes shall be dismissed with prejudice and Sikes' debt to BancBoston shall be declared dischargeable. An appropriate order will be entered accordingly.

ENTER this 12 day of September, 1990.

/s/ Keith M. Lundin
KEITH M. LUNDIN
UNITED STATES
BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE

IN RE:	)	CASE NO.
	)	388-08502
THOMAS E. LEDFORD,	)	CASE NO.
J. GREGG SIKES,	)	389-00645
	)	
Debtors,	)	CHAPTER 7
	)	
BANCBOSTON MORTGAGE	)	JUDGE KEITH M.
CORPORATION,	)	LUNDIN
	)	
Plaintiff,	)	
	)	ADV. NO. 389-0154
v.	)	AND NO. 389-0155
	)	(CONSOLIDATED)
THOMAS E. LEDFORD and	)	
J. GREGG SIKES,	)	
	)	
Defendants.	)	
	)	

JUDGMENT
(Filed June 22, 1990)

For the reasons stated in the memorandum filed contemporaneously herewith, IT IS ORDERED, ADJUDGED AND DECREED that judgment be entered for the Plaintiff and against the Defendant, Thomas E. Ledford, for the debt of the Defendant, Thomas E. Ledford, to the Plaintiff; the amount of said debt to be hereafter determined, for all of which execution may issue if necessary.

IT IS HEREBY FURTHER ORDERED, ADJUDGED AND DECREED that the foregoing judgment shall be a nondischargeable debt of Defendant, Thomas E. Ledford, being a debt for money, property, services, or an extension, renewal or refinancing of credit, obtained by false pretenses, a false representation, or actual fraud under 11

U.S.C. Section 523(a)(2)(A), which debt shall be and is hereby excepted from the discharge of Defendant, Thomas E. Ledford, under 11 U.S.C. Section 523(c).

IT IS HEREBY FURTHER ORDERED, ADJUDGED AND DECREED that the entry of an order granting a discharge to Defendant, Thomas E. Ledford, shall not operate as an injunction under 11 U.S.C. Section 524(a)(2), or otherwise, against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset said judgment as a personal liability of Defendant, Thomas E. Ledford, and the personal liability of Defendant, Thomas E. Ledford, to Plaintiff for said judgment shall continue notwithstanding the entry of an order granting a discharge to Defendant, Thomas E. Ledford.

DATED this 22 day of June, 1990.

/s/ Keith M. Lundin
KEITH M. LUNDIN
UNITED STATES
BANKRUPTCY JUDGE

APPROVED FOR ENTRY:

/s/ Paul S. Davidson
Paul S. Davidson

/s/ D. Reed Houk
D. Reed Houk

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Attorneys for Plaintiff,
BancBoston Mortgage Corporation

IN THE UNITED STATES BANKRUPTCY COURT FOR THE
MIDDLE DISTRICT OF TENNESSEE

IN RE:	)	CASE NO.
THOMAS E. LEDFORD, J. GREGG SIKES,	)	388-08502
	)	CASE NO.
	)	389-00645
Debtors,	)	CHAPTER 7
BANCBOSTON MORTGAGE CORPORATION,	)	JUDGE KEITH M. LUNDIN
	)	
Plaintiff,	)	ADV. NO.
v.	)	389-0154 AND NO.
	)	389-0155
THOMAS E. LEDFORD and J.GREGG SIKES,	)	(CONSOLIDATED)
	)	
Defendants.	)	
	)	

MEMORANDUM
(Filed Jun 21 90)

In these consolidated adversary proceedings, Plaintiff, BancBoston Mortgage Corporation ("BancBoston"), seeks a determination of the dischargeability of the debts of Defendants, Thomas E. Ledford ("Ledford") and J. Gregg Sikes ("Sikes") to BancBoston under 11 U.S.C. Section 523(a)(2)(A). This is a core proceeding under 28 U.S.C. Section 157(b)(2)(I).

The issues presented are:

1. Whether the debt of Ledford and/or Sikes to BancBoston is nondischargeble under 11 U.S.C. Section 523(a)(2)(A).

2. Whether the false pretenses, false representations and/or actual fraud on the part of Ledford may be imputed to Sikes for purposes of determining the dischargeability of his debt to BancBoston under 11 U.S.C. Section 523(a)(2)(A).

3. Whether BancBoston can prove clearly and convincingly that Ledford intentionally deceived BancBoston and thereby incurred a debt for money obtained by actual fraud.

4. Whether concepts of vicarious or imputed liability can support a claim of nondischargeability under 11 U.S.C. Section 523(a)(2)(A).

5. If any amount is determined to be nondischargeable, what is the amount of the debt that is nondischargeable.

The following constitute findings of fact and conclusions of law under Bankruptcy Rule 7052.

In order to prevail under 523(a)(2)(A), the plaintiff has the burden to prove by clear and convincing evidence that there was a misrepresentation or a false pretense that related to a then existing fact, that it was knowingly done, that it was materially false, and that there was reliance, causation and damages. The Court has reviewed the testimony and documentary evidence presented over three days of trial, has examined the record and arguments of counsel, has read the stipulations of the parties, and has considered the applicable case law. For the reasons discussed below, the Court finds that the evidence

presented is clear and convincing that by false pretenses and misrepresentations Ledford obtained construction loan proceeds from BancBoston, and the Court finds for BancBoston under Section 523(a)(2)(A) of the Bankruptcy Code.[1]

In April, 1986, Ledford, as a general partner of Montclair, Ltd., a Tennessee limited partnership ("Montclair"), and as President and sole stockholder of Ledford Properties, Inc. ("Ledford Properties"); the developer retained by Montclair, secured from BancBoston a loan in the amount of One Million Six Hundred Thousand Dollars ($1,600,000.00). The purpose of the loan was to provide funds to acquire land on West End Avenue in Nashville, Tennessee upon which Montclair intended to develop a condominium project to be known as The Montclair. On or about October 2, 1986, the loan documents were amended to increase the principal amount of the loan to Six Million Two Hundred Twenty-Five Thousand Dollars ($6,225,000.00). This increase in the loan amount was to enable construction of The Montclair condominium project.

Pursuant to the terms of amended commitment letters from BancBoston and the amended loan documents,

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[1] At the close of plaintiff's proof, the Court dismissed plaintiff's complaint against Sikes, finding insufficient evidence to prove clearly and convincingly that Sikes participated in or had knowledge of Ledford's actions, and that Ledford's fraud could not be imputed to Sikes as a matter of law. The Court has entered separate findings of fact and conclusions of law with respect to Sikes.

Montclair was required to obtain fourteen (14) contracts for sale of the condominium units in the project.[2] With respect to the "pre-sale" contracts, the amended loan documents provided that: the contracts would be legally enforceable with bona fide third-party purchasers; the contracts would be entered into upon forms approved by BancBoston; the contracts would comply with certain minimum sales price and earnest money deposit requirements; the contracts would not be changed, modified, extended, terminated or amended without the prior written consent of BancBoston; and the borrower would not do or fail to do any act which would enable the purchaser under a contract to terminate the contract without forfeiture of the purchaser's down payment or earnest money. BancBoston had no obligation to fund the construction loan to Montclair until the fourteen (14) pre-sale contracts were obtained.

There were two very obvious or visible efforts to comply with the pre-sale contract requirement. First, beginning in May 1986, there were the efforts through outside real estate agents. Second, there were inside

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[2] The original loan commitment from BancBoston required twenty (20) pre-sale contracts on pre-approved forms. In September, 1986, there was an amendment to the loan commitment which reduced the required number of pre-sale contracts from twenty (20) to fourteen (14). As consideration for the reduction in the number of pre-sale contracts, BancBoston required a One Hundred Thousand Dollar ($100,000.00) increase in a Seven Hundred Fifty Thousand Dollar ($750,000.00) letter of credit Montclair had posted as part of the security for the construction loan.

efforts by Ledford, employees of Ledford Properties, and friends of those employees, and contractors hired by Ledford Properties to very quickly generate the contracts. It is in this latter area of the effort to obtain pre-sale contracts that the Court finds misrepresentations and false pretenses were made.

Montclair first engaged the services of Fridrich & Hooper, real estate agents, to obtain pre-sale contracts. Ms. Karen Badger, initially engaged as an agent with Fridrich & Hooper and later engaged as an independent contractor by Ledford Properties, obtained two pre-sale contracts (Sands and Tant) in June, 1986, and was instrumental in obtaining an additional pre-sale contract (Layman) in September, 1986. Another contract obtained by outside real estate agents, but not counted toward the pre-sale contract requirement, was the contract executed by Mr. and Mrs. Piot in January, 1987.

The contracts obtained through outside real estate agents, that is, the Layman, Tant, Sands, and Piot contracts, appear to have been very above-board ordinary real estate contracts. In some cases contingencies were added; and, for example, in the Sands and Tant contracts, contingencies initially included in the contracts were negotiated out. The contracts went back and forth between the outside real estate agents and Ledford and then were sent on to BancBoston in the normal way.

In early to mid-September, 1986, Ledford testified at trial that he made a determination to go ahead with the development of this project even though he had received

an offer to sell the property to another developer. In accordance with that determination, Ledford further testified at trial that he became more personally involved and made a real push to obtain the required number of pre-sale contracts necessary in order to obtain construction financing from BancBoston. At Ledford's request, BancBoston agreed to close the loan in October of 1986 (before the required number of pre-sale contracts had been obtained) so that the contractor's demands to see construction financing in place could be met, and so that construction could begin before winter. Although the loan was closed on October 2, 1986, and construction began on October 6, 1986, BancBoston made it clear and Ledford knew that it would not disburse any proceeds from the construction loan for construction of the project until after Montclair acquired the required number of pre-sale contracts.

By November 19, 1986, Montclair had presented to BancBoston the required fourteen (14) pre-sale contracts which, on their face, complied with all conditions of the loan documents. The contracts submitted are listed below in order of their contract date:

Buyer	Contract Date
Sands, Randall	6-16-86
Tant, Cliff	6-16-86
Sanders, James, Jr.	8-25-86
Sanders, James, Jr.	8-25-86
Molteni, Tommy	9-10-86
Sanders, Steven	9-10-86
Hill, Joel	9-24-86

Ragan, Berney	9-24-86
Layman, George	9-26-86
Jung, Richard	9-30-86
Molteni, Philip	10-03-86
Battle, E.A.	10-23-86
Denny, Lewis	10-30-86
Strickland, Thomas	10-30-86

The key contracts and key facts relevant to the Court's finding regarding Ledford's liability relate to contracts obtained by the inside efforts; that is, the J. Sanders, Lewis Denny, Joel Hill, Berney Ragan, Richard Jung, and to a lesser extent, the Thomas Strickland contracts. These contracts were not above-board ordinary contracts, in that contingencies were added by way of addendum or by verbal side agreements which were not disclosed to BancBoston.

At trial, BancBoston called Ledford as its first witness. In fact, the Court heard testimony from Ledford on several occasions during the course of trial. His explanation of what happened with respect to the pre-sale contracts is essentially a three-step evolution. Ledford first testified that he did not know either about the addendums or any side agreements with purchasers until maybe 1988; and that the executive vice-president of Ledford Properties, George Tomlin ("Tomlin"), had entered into the side agreements and contingency addendums without his knowledge or approval. Later in the trial, the Court heard testimony from Ledford that he may have known about a few of the contingencies executed by addendum when his company sought extensions of the

closing dates for some of the pre-sale contracts in the Spring of 1987. Later in the trial, the Court heard yet a third explanation from Ledford which was that he knew specifically in mid-February, 1987, about the Hill, Jung and J. Sanders' contingencies or addendums.

The evolution in Ledford's testimony also marks an evolution in the presentation of evidence from other witnesses. It is the Court's view that Ledford's story developed during the course of this trial. His evolution of explanations failed to rebut the clear and convincing evidence presented by BancBoston that he had actual knowledge of the existence of contingencies to the pre-sale contracts added by separate addendum and/or of other conditions to the contracts that prevented the contracts from being acceptable as pre-sale contracts at the time the contracts were originally executed.

By way of example, when Ledford first testified relative to an addendum to the J. Sanders contract, he testified that he did not remember agreeing to a financing contingency with Mr. Sanders. At the end of the trial, the Court heard a different explanation from Ledford that this was one of the addendums that Ledford became aware of in February, 1987. As part of its case in chief, BancBoston has shown that Mr. Sanders told Ledford at the time he executed the original contract that his contract was contingent on a divorce. Mr. Sanders also testified that at the time he signed the contract he discussed a financing contingency with Ledford. Thus, there were essentially two contingencies in Mr. Sanders' contract. One had to do with his divorce and the other with financing. The financing contingency was reduced to writing, the divorce contingency was a verbal agreement. It is not

necessary for the Court to determine whether the divorce contingency as a matter of law would have been enforceable had Mr. Sanders been brought into Court to close on his contract. What is relevant, however, is whether Ledford agreed with Mr. Sanders back in August of 1986 that if the divorce didn't work out Mr. Sanders would not have to close his contract. Mr. Sanders testified that is the way it happened and his version of the events is corroborated by the testimony of Sikes' financial advisor, Al Mifflin, who testified that he knew about the Sanders contract and the divorce contingency in February, 1987. The Court accepts Mr. Sanders' version of the events and so finds that Ledford was aware of both the divorce and the financing contingencies at the time the contract was executed in August, 1986. The Court also finds that Mr. Sanders signed his financing contingency at the time he signed his original contract in August, 1986, that the pre-sale contract was submitted to BancBoston without the financing contingency, that the divorce contingency was not communicated to BancBoston at the time the pre-sale contract was submitted to them, and that Ledford knew these contingencies would not have complied with the requirements of BancBoston for an acceptable pre-sale contract.

Another example of the evolution of Ledford's explanations is presented by the contingencies to Mr. Hill's and Mr. Jung's contracts. Ledford first explained that he found out about these contingencies in the middle of 1987. He later testified that he believed he found out in March, 1987. His last explanation was that he found out in the course of a conversation with Tomlin in the middle

of February, 1987. According to Ledford's last explanation, he first learned in February, 1987 that Tomlin had given financing contingencies to Mr. Hill and Mr. Jung and to Mr. Sanders. Ledford explained that when he learned of what Tomlin had done, he instructed Tomlin to go back and get the contingencies reduced to writing. Contrary to Ledford's testimony, Mr. Hill and Mr. Jung both testified that their financing contingencies were executed at the same time their original contracts were executed in September, 1986. Mr. Hill further testified that the financing contingency was his "out"; and that he didn't have any reason to doubt that he had a way out of the contract. Based on his understanding of the contingency, Mr. Hill brought his partner, Richard Jung, into the deal.

Mr. Jung and Mr. Hill were partners in the security company that had a contract at this project. Jung testified that he met Ledford through Hill at Ledford's offices and that Ledford did a sales pitch to him with respect to purchasing a condominium unit. Jung agreed to execute a contract, but demanded the same contingency that Hill had received in his contract. Jung's testimony was clear and convincing that he signed the addendum at the same meeting in Ledford's office when he signed his contract in September, 1986. This contingency is one that Ledford last testified he became aware of for the first time in mid-February, 1987.

Hill's and Jung's version of the facts were consistent with each other and with the other pre-sale contract purchasers' testimony that the contingencies were part of their original contracts and that they were signed at the time of the original contracts in August or September of

1986. No one has testified, not Tomlin, Hill, Jung, Sanders, Ragan, nor any employee of Ledford Properties, about going back and getting contingencies to the contracts signed in mid-February, 1987. The Court finds Mr. Jung's and Mr. Hill's explanations of what happened to be correct and that their memory of events is clear and convincing. Ledford's explanation, on the other hand, is not credible. It does not make sense that Ledford would have instructed Tomlin to go back to purchasers in the middle or latter part of February, 1987, to get financing contingencies on contracts executed in August and September, 1986, when the financing contingencies would have expired according to their terms on March 1, 1987. If this had in fact happened, someone would have had a memory of it other than Ledford. The Court finds as a matter of fact that Mr. Hill and Mr. Jung both signed the contingencies at the time they signed their original contracts. The Court further finds that these pre-sale contracts were submitted to BancBoston without the contingencies, and that that was known to Ledford at that time.

Berney Ragan, another pre-sale contract purchaser, testified at trial that he was a loan officer at Metropolitan Federal Savings and Loan Association, a savings and loan institution in Nashville. Prior to executing a pre-sale contract, he had approved and extended loans from Metropolitan Federal to Ledford on this and other projects. Mr. Regan was the loan officer that Ledford had been dealing with at Metropolitan Federal. Ragan's pre-sale contract also had financing contingencies by way of separate written addendum. Ragan testified that his addendum with the financing contingency was executed on the day of the

original contract, which was September 24, 1986. The proof at trial was that his attorney had been involved in the negotiation of the addendum and that Ragan believed he had spoken to Ledford about this as well as other issues. Ledford first testified that he did not know Ragan's contract had financing contingencies; and that the contingencies were executed by Tomlin without his authority. Ledford's second version was fairly consistent with the first, but then toward the end of trial, Ledford testified for the first time that he knew about the Ragan contract and the contingency in the middle of 1987. The Court finds Mr. Ragan's testimony to be credible while Mr. Ledford's was not credible. The Court finds as a matter of fact that Mr. Ragan signed his financing contingency at the time he signed his original contract in September, 1986, that the pre-sale contract was submitted to BancBoston without the contingency, and that that was known to Ledford at the time.

Thomas Strickland, another pre-sale contract purchaser, was a stockbroker who had worked for many years with Tommy Molteni. Tommy Molteni was the brother of Philip Molteni, another pre-sale contract purchaser, and Tommy Molteni was an employee of Ledford Properties. The Moltenis were friends of Strickland. It is clear from Mr. Strickland's testimony at trial that although he executed a pre-sale contract, he never had any intention of purchasing a condominium unit at The Montclair. He never reviewed the contract, he did not arrange for the earnest money letter of credit (Ledford Properties did), nor did he select a unit. The Court finds

that the Strickland contract was simply an accommodation by Strickland through his friendship with the Moltenis and Tommy Molteni's employment with Ledford Properties.

The Lewis Denny pre-sale contract was perhaps the clearest and most damaging piece of evidence in the trial. Lewis Denny was a $30,000 a year employee of Ledford Properties. He started working for Ledford Properties in August, 1986, as a development analyst. In early to mid-September, 1986, he was approached by Ledford to purchase a condominium unit at The Montclair. The timing of this corresponds with Ledford's testimony that in the Fall of 1986 a decision was made by him to go ahead with this project and to make a real push to obtain the remaining required pre-sale contracts in order to obtain construction financing from BancBoston.

Mr. Denny testified at trial that he did sign a contract after some discussion with Ledford. The contract was negotiated with Ledford and then there was an earnest money letter of credit obtained on behalf of Mr. Denny in order to complete the requirements of the contract. The proof at trial showed that Ledford Properties reimbursed Denny for the letter of credit in order to pay Denny back for the security for the contract. Denny also testified at trial that at the time he signed the original contract he told Ledford that he would not be able to financially qualify for a loan to purchase the unit; but apparently that did not matter. In mid-October, 1986, before BancBoston accepted the required fourteen (14) pre-sale contracts, Denny testified at trial that he told Ledford and Tomlin that he would not buy a unit because he and his wife had found a home in Clarksville, Tennessee. Denny's

contract was one of the fourteen (14) presale contracts submitted to BancBoston.

The Court was offended by the testimony surrounding the Denny contract. Mr. Denny's contract was a coerced contract under the best of circumstances. It is very clear to the Court that Ledford knew the Denny contract was a fake. At the very least, the Denny contract should not have been submitted to BancBoston or it should have been withdrawn once Mr. Denny made it clear that he had no intention of closing. The Court finds that BancBoston has submitted very clear and convincing evidence of actual knowledge by Ledford that the Denny contract was not a valid pre-sale contract at the time it was presented to BancBoston.

The testimony of other witnesses at trial corroborates the testimony presented by the pre-sale contract purchasers recounted above. A turning point in the evidence was the testimony of Sikes' financial adviser, Al Mifflin. Mifflin was one of the few real outside people that had contemporaneous evidence that had no possibility of taint. What he brought to the trial were the notes of his secretary or assistant taken on February 27, 1987, when he first met with Ledford. Mifflin's assistant made critical notes showing that on February 27, 1987, Ledford was very much aware of at least five (5) of the contingencies that existed in contracts that had been submitted to BancBoston. February 27, 1987, thus fixes the outside date on when Ledford could have known about the contingencies and it suggests that he had to know about the contingencies before that date.

Mifflin's testimony also essentially did away with the explanation Ledford gave during his first testimony that he did not have any information or knowledge of these contingency contracts or addendums until sometime in 1988 when he magically discovered a file of addendums while preparing for discovery in a case related to Montclair's bankruptcy. Mifflin's testimony forced Ledford's story to change. It was after Mifflin testified that Ledford's testimony became more and more creative as he made an effort to explain how he could have known about these contracts and yet not told BancBoston about them. As previously stated, Ledford's first version of what happened relative to Jung and Hill was that he learned of the contingencies he claims were granted by Tomlin in March of 1987. After Mifflin testified, Ledford's testimony backed that date up from March to the middle of February. The third version of this story was from Hill and Jung, which the Court believes to be the correct story.

George Tomlin testified at trial that he participated in the drafting of the addendums that dealt with the original financing contingencies and that he may have had help from the law firm that represented Ledford Properties. He testified that he first had discussions about the financing contingencies with Ledford in June of 1986. Tomlin's testimony is consistent with the testimony of Hill, Jung, Ragan, Sanders, and Mifflin. It is also consistent with a review of the documents themselves. The Court's review of the financing contingencies suggests they sprouted from the same seed. Many of the contingencies contained identical language, the same dates, and even the same typeface. When placed in juxtaposition to the contracts submitted by the outside real estate agents,

the Court finds that the financing contingencies granted by Tomlin and Ledford had to have existed at some earlier time and that the contingencies were not coming from five or six different sources, but were coming from one source and were part of what Ledford was willing to have in the contracts.

Ledford's testimony that Tomlin was instructed to go back and create the financing contingencies in February, 1987, with respect to the Jung, Hill and J. Sanders contracts is completely inconsistent with all the other evidence produced in the case. It is also inconsistent with Ledford's description of his relationship with Tomlin. Ledford would have the Court believe that Tomlin was a bad character, that he did terrible things and that he was eventually driven out of the company in December of 1987 because of his bad conduct. If in February of 1987, Ledford was shocked to discover Tomlin had engaged in this monumental fraud behind his back, with Tomlin creating fake contracts and not telling him about them, then different things would have happened. Instead, as discussed below, Tomlin remained an employee of Ledford Properties, but the outside real estate agents abandoned the enterprise.

Tomlin further testified at trial that he did not enter into any separate addendums or contingencies that Ledford did not first know about and authorize. The Court has weighed the credibility of the various witnesses and finds that Tomlin's explanation of events is correct; that is, he is exactly right that Ledford knew about the contingencies at the time they were executed. Ledford's explanation of what happened is absurd. The Court finds as a matter of fact that Ledford was aware of the addendums

and aware of the contingencies in the pre-sale contracts in the Fall of 1986 before the contracts were submitted to BancBoston and before the contracts were accepted by BancBoston as part of the fourteen (14) pre-sale contract requirement.

Further corroborative evidence was presented by Karen Badger, the independent real estate agent. Ms. Badger testified at trial that she became fed up with the way things were happening at Ledford Properties and that she angrily parted company with Ledford Properties in early 1987. She also testified about a meeting which took place at the offices of Ledford Properties in or about October 1986, where Ledford looked over pre-sale contracts to be submitted to BancBoston and removed addendums and financing contingencies from the base contracts saying "we don't need to send these on to BancBoston" or some other similar language. The Court believes some of the things Ms. Badger testified to are hyperbole, but that the flavor of what she testified to is not. The flavor is that the outside agents, the ones who had independent brokerage contracts or who were outside the Ledford Properties' organization, brought contracts at the very early stages that were handled in the way real estate contracts are normally handled. The Court finds the fact that these contracts were handled differently than the contracts that came in from inside sources significant.

Another piece of evidence which corroborates the stories of everyone but Ledford is the Layman contract. The Layman contract was one of the contracts presented to Ledford Properties by outside real estate agents. The Layman contract was processed in the ordinary way that

the parties might have expected the contracts to be processed. It had a financing contingency signed by Ledford at the time the contract was executed and it was sent to the Bank. The evidence shows, however, that the Bank simply did not catch the Layman contingency and it accepted the Layman contract as one of the required pre-sale contracts. Ledford's testimony was that Tomlin had to get his permission in order to have such a contingency. The Court is unable to understand why Tomlin would hide the rest of the financing contingencies from Ledford if the one contract that was openly dealt with by everyone went through and was accepted by the Bank.

To give Ledford the benefit of the doubt, the Court searched for evidence of motive and opportunity to explain Ledford's contorted theory of why Tomlin was not telling the truth; why Hill, Jung, Sanders and Ragan were mistaken. The Layman contract, however, makes the explanations of Tomlin, Hill, Jung, Ragan and Sanders clearly and convincingly more believable then [sic] Ledford's explanation. The Layman contract served to corroborate the testimony of the pre-sale contract purchasers and Mr. Tomlin because it had a financing contingency. The Court also notes that Ledford signed eight (8) of the original fourteen (14) pre-sale contracts and that he signed at least two (2) of the addendums that he claims not to have known about until February, 1987, that is, the Jung and Sanders' addendums.

The Court concludes that BancBoston has demonstrated clearly and convincingly that Ledford made material misrepresentations with respect to the pre-sale contracts. The Court finds that Ledford either personally or at his direction submitted contracts which on their face complied with the

requirements of the loan documents, but which he knew did not comply. Ledford's misrepresentations were clearly material to BancBoston. BancBoston's loan officers testified at trial that the purpose of the pre-sale contracts were: (1) to be certain of the existence of a market for these properties; (2) to show that there was an acceptance of the developer in the particular market; (3) to show at completion of the construction of the project a substantial principal reduction of the loan; and (4) to make it easier to sell the remainder of the units because some had previously been sold. BancBoston proved by clear and convincing evidence that it would not have funded construction costs for the project from the construction loan in December, 1986 had it known that many of the contracts had contingencies and addendums and that some of them were not even real contracts at all.

Ledford's counsel argued at trial that the fact that BancBoston was willing to close the construction loan in October, 1986, knowing that construction would begin on the project before it actually had in hand the fourteen (14) pre-sale contracts demonstrates the lack of materiality of the pre-sale contracts. The Court finds that this is not a problem in the outcome of the case. A critical reason is that there was a condition on the loan closing that there would be no advances against the construction loan for construction costs for the project until the fourteen (14) pre-sale contracts were in hand at BancBoston and accepted by them. In fact, BancBoston did refuse to disburse loan proceeds for construction costs until after the pre-sale contracts were obtained. No money was advanced for construction costs until December, 1986, and it is clear that December of 1986 is after the fourteen (14) pre-sale contracts had been submitted by Ledford

and approved by BancBoston. BancBoston has demonstrated clearly and convincingly that those fourteen (14) pre-sale contracts were a critical part of the decision to advance the money for the construction of the project and there is accordingly no damage done to the materiality element that the Bank was willing to close the construction loan early in October, 1986.

The Court also concludes that BancBoston met its burden of showing clearly and convincingly that at the time Ledford submitted the pre-sale contracts to BancBoston he knew they did not comply with the loan documents. Ledford has a master's degree in public administration; and has substantial experience in the housing development industry and in the securities industry. He is a real estate developer who had the day-to-day responsibility of all aspects of The Montclair condominium project, including the securing of pre-sale contracts to satisfy the pre-sale contract requirement of the construction loan agreement with BancBoston. The Court finds that Ledford had actual knowledge that many of these contracts were not then existing real contracts. Ledford either personally or at his direction caused a misrepresentation to be made to BancBoston concerning the pre-sale contracts.

The Court concludes further that Ledford made the representations with the intention and purpose of deceiving BancBoston. Ledford testified at trial as stated above that Montclair arranged to purchase the property in the Spring of 1986 and that a decision was made in the Fall of 1986 not to simply sell the property, but to go ahead and actually develop it with a construction contract with Hardaway Construction Company. At that point, Ledford

testified that he became seriously, intimately and daily involved in the process of complying with the requirements of the construction loan documents with BancBoston. At the time the final determination to go ahead was made, Ledford determined there was a need to put a real push on to get the required pre-sale contracts. It was during this time period that a number of the "insider" contracts were obtained such as, for example, the Lewis Denny contract described above. The Court finds that Ledford made the misrepresentations at issue with the intent and purpose of deceiving BancBoston in order to induce BancBoston to fund construction costs for the project from the construction loan.

Ledford further contends in his defense that BancBoston did not reasonably rely on the pre-sale contracts. Ledford raises two red herrings relative to his reliance argument. The first, as the Court has discussed above, is the timing of the closing of the construction loan and the actual submission of the fourteen (14) pre-sale contracts. The timing of the loan closing does no violence to the clear and convincing evidence of BancBoston's actual reliance on these fourteen (14) contracts. The second red herring is that the closing dates set forth in the fourteen (14) pre-sale contracts pre-dated the outside date set forth in the Hardaway Construction contract for the completion of the project.

The fact that the closing date on some or all of the pre-sale contracts were close to or before the possible outside completion date under the construction contract does not take away from the fact that if these were bona fide contracts they would have shown the existence of a market and the acceptance of the developer. These are

two of the four key factors BancBoston looked at in requiring these contracts. Moreover, it was explained at trial by BancBoston representatives that both Ledford and Tomlin represented to BancBoston that, the completion date in the construction contract notwithstanding, the project could be finished in time to meet the closing dates in the pre-sale contracts. Further, Tomlin and Ledford represented to BancBoston that the pre-sale contract purchasers had, in any event, expressed a willingness to execute extensions to keep the closing dates in their contracts consistent with the completion date of the project. In actual fact, extensions were accomplished in most of the contracts as promised by Ledford and/or Tomlin.

Plaintiff proved clearly and convincingly that it relied on the validity of these pre-sale contracts. Mr. Hudspeth, the responsible loan officer with BancBoston, accurately testified for BancBoston that none of the addendums or contingency agreements were provided to BancBoston relative to the fourteen (14) pre-sale contracts other than the Layman contract discussed above. Despite argument of Ledford's counsel, the Court is aware of no case which would impose on a commercial lender under these circumstances the requirement, for example, to call up the parties to these contracts to make sure the contracts were valid. BancBoston had every reason to believe that the contracts were valid. They had previous dealings with Ledford in the Park Circle Condominium project, where they had had pre-sale contracts properly submitted; thus BancBoston had no reason to suspect that any of these contracts were improper. BancBoston did check to see that each contract was on the pre-approved form, that the signatures were right, that the prices were right, and

that the earnest money deposits under the contracts met their requirements. BancBoston refused to count contracts submitted with unauthorized contingencies. BancBoston offered evidence that demonstrated that the Piot contract, for example, was not counted toward the pre-sale requirement because of contingencies. The Court finds that BancBoston did all that was required in terms of supporting and justifying their reliance on the pre-sale contracts submitted.

The final element of a Section 523(a)(2)(A) claim is one of causation and damages. The Court heard testimony from BancBoston representatives, and is convinced most clearly, that BancBoston would not have funded construction costs for the project from the construction loan in December of 1986 had it known that many of the contracts had contingencies and addendums and that some contracts were not even real contracts. The Court finds that the advances of construction monies are related in every possible way to Ledford's misrepresentations about the fourteen (14) pre-sale contracts.

In regard to the causation and damages issue, Ledford raises a third red herring in his defense. Ledford demonstrated that BancBoston may have had a contractual participation agreement with The First National Bank of Boston in connection with the construction loan to Montclair. It is not a defense for the defendant in a dischargeability claim that the plaintiff may be sharing its exposure or its liability as a matter of contract with some other bank or some other party. A participation agreement is not a reason why BancBoston is not entitled to a judgment for the full amount of its claim against Ledford. Absent evidence that there has actually been a transfer of

the claim or the right to collect on the cause of action, the existence of a participation agreement is simply no defense. No such evidence was presented.

Damages in this case have to be measured against the original contract between the parties and whatever funds were advanced for construction of this project, whatever funds were used for the project, whatever funds were put in to complete the project to get the property ready to sell, to actually sell it, the expenses of selling it, everything, in fact, that BancBoston would be entitled to in an action in State court is part of its damages; and BancBoston is entitled to fully recover those damages in this Court. On the other hand, the debtor is entitled to offset against the claim those amounts received by BancBoston from letters of credit, the sale of condominium units, funds realized at the auction sale of this property, plus the income from the property, if there was any, while BancBoston was trying to sell the property, and the remainder value of the life estate in the Sonnenfield property adjacent to The Montclair previously owned by Montclair and foreclosed and now owned by BancBoston. BancBoston offered evidence that its total claim is in excess of Two Million Dollars ($2,000,000.00). That number is not yet precise, but the lack of precision is not a problem with the nondischargeability of the claim. It is simply a matter of further accounting and the relationship of these parties. The contract at issue here will control the ultimate amount Ledford will be required to pay in the future on account of this nondischargeable claim.

The Court finds that the evidence is clear and convincing that by false pretenses and misrepresentations

Ledford secured construction loan advances from BancBoston and that BancBoston has met its burden of proof on every element under Section 523(a)(2)(A) of the Bankruptcy Code. Ledford failed to rebut BancBoston's clear and convincing proof. For all the foregoing reasons, the Court finds for BancBoston under Section 523(a)(2)(A) of the Bankruptcy Code.

An appropriate Judgment will be entered.

DATED this 22 day of June, 1990.

/s/ Keith M. Lundin
KEITH M. LUNDIN
UNITED STATES
BANKRUPTCY JUDGE

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing Memorandum has been served on William Caldwell Hancock, Esq., 303 Church Street, Suite 102,

Nashville, Tennessee 37201; Paul E. Jennings, Esq., 303 Church Street, Suite 101, Nashville, Tennessee 37201; and the United States Trustee, 701 Broadway, Suite 318, Nashville, Tennessee 37203, by depositing the same in the United States Mail, first-class, postage prepaid, this 21st day of June, 1990.

/s/ D. Reed Houk
D. Reed Houk

Supreme Court, U.S.
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No. 92-1057

In The

Supreme Court of the United States

October Term, 1992

IN RE: J. GREG SIKES,

Debtor.

J. GREG SIKES,

Petitioner,

vs.

BANCBOSTON MORTGAGE CORPORATION,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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RESPONDENT'S BRIEF IN OPPOSITION

COUNTER-STATEMENT OF THE CASE

The claim in Petitioner's Statement of the Case that Sikes was simply a passive investor "whose sole role in the Montclair partnership consisted of obtaining letters of credit and executing a limited guaranty to the lender"

[1] Pursuant to Rule 29.1 of the Supreme Court Rules, Respondent discloses that it is a wholly owned subsidiary of the First National Bank of Boston, which is a wholly owned subsidiary of the Bank of Boston Corporation, a publicly owned corporation.

(Pet. 5), is not true. Sikes was in fact a knowledgeable general partner actively involved in partnership affairs, and thus entitled to nearly half the partnership's profits. Prior to becoming a general partner in Montclair, Ltd., Sikes had entered into several other financial dealings with Ledford as a joint venturer, general partner and/or limited partner. Trial Transcript ("TR") at 2-72.[2] He understood the difference in responsibilities and liabilities between a limited partner and a general partner; and he signed, as a general partner, not just letters of credit and a guaranty as alleged in the Petition, but all of the loan documents. *Id.* at 2-73, 74.

While Sikes' partner, Thomas E. Ledford ("Ledford"), was eliciting the fraudulent pre-sale contracts, Sikes would call him on a weekly or biweekly basis to monitor the condominium sales. TR at 2-82. Sikes and his personal financial manager had free access to all the records and personnel relating to the partnership. *Id.* at 2-83. Shortly after the required number of pre-sale contracts were submitted to BancBoston, Sikes inquired about the pre-sale contracts and Ledford told him about one contract where the purchaser had been granted a contingency. *Id.* at 2-75.

Thereafter, Sikes directed his financial manager to review documents relevant to the project and interview Ledford. *Id.* at 2-80. Sikes' financial manager met with Ledford to discuss, among other things, Ledford's success in meeting the "pre-sale" requirements, and Ledford informed him that, of the pre-sale contracts submitted to BancBoston, five had contingencies or "outs" and eleven did not. *Id.* at 2-77 and *see*

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[2] Referenced pages of the Trial Transcript are set forth in the Appendix beginning at App. 2.

typed notes of Sikes' financial manager's meeting with Ledford (handwritten copies admitted into evidence as Exhibit 25) (App. 17, 18). The financial manager told Sikes about the "outs" in the pre-sale contracts after his meeting with Ledford. TR at 2-77, 79. When his financial advisor told him about the "outs" Sikes knew that a condition precedent to disbursement of the loan proceeds was the submittal of *bona fide* pre-sale contracts. *Id.* at 2-75. Because Sikes executed the loan documents containing the conditions relating to the pre-sale requirements, and he was told about the "outs," he should have been aware of Ledford's fraud.

At the close of BancBoston's proof at trial, Sikes elected to move for dismissal, thereby relinquishing his right to offer evidence in the event the motion was granted. *See* FED. R. CIV. P. 41(b). The bankruptcy court granted Sikes' motion, ruling that because BancBoston had not proven clearly and convincingly that Sikes knew or should have known of Ledford's fraudulent conduct, Ledford's fraud could not be imputed to him. BancBoston timely filed its appeal to the district court. In Sikes' arguments on appeal, he did not request the case be remanded for a new trial in the event the bankruptcy court was reversed; he did not even suggest he had additional evidence to rebut BancBoston's proof on the elements of the nondischargeability complaint (in fact, Sikes adopted Ledford's arguments on the evidence in their entirety); and he did not raise the procedural due process issue he now attempts to raise before this Court.

The district court reversed the bankruptcy court and ruled that Ledford's fraud and the resulting debt to BancBoston could be imputed to Sikes under Section 523(a)(2)(A) of the Bankruptcy Code. Sikes appealed to the United States Court of Appeals for the Sixth Circuit. The Sixth Circuit affirmed the district court's opinion.

Sikes did not request a remand or raise a procedural due process issue until he filed his reply brief.

REASONS FOR DENYING THE PETITION

SUMMARY OF ARGUMENT

Petitioner relies upon a conflict between the Eighth Circuit and the Sixth Circuit for his argument that the grant of certiorari is necessary. The apparent conflict between the Eighth Circuit and the Sixth Circuit on the issue presented, however, no longer has practical significance. Recent court decisions have rejected the Eighth Circuit's reasoning, demonstrating a determination to follow the binding pre-Code precedent established over a century ago in *Strang v. Bradner*, 114 U.S. 555 (1885). In *Strang*, the Court declared that the fraud of an authorized agent, without more, was grounds for the non-dischargeability of the principal's debt *relating to his agent's fraud*. This rule was followed unanimously up to passage of the Bankruptcy Code of 1978. And, in enacting Section 523(a)(2)(A) of the Bankruptcy Code of 1978, Congress expressed an intent to codify existing case law. The Eighth Circuit's opinion, which has not been adopted by any other Circuit Courts of Appeal, is in direct contravention of the rule set forth in *Strang* and, according to the legislative history of Section 523(a)(2)(A), the Bankruptcy Code of 1978.

Sikes asserts that he was denied his constitutional right to due process. However, Sikes elected to move for involuntary dismissal at the close of plaintiff's proof at trial, thereby foregoing his right, when the bankruptcy

court granted his motion, to go forward with evidence in opposition to Respondent's required showings under Section 523(a)(2)(A). Moreover, Sikes' procedural due process arguments are not properly before this Court because he failed to timely raise them in the courts below.

ARGUMENT

I. The Lower Court's Ruling Presents No Conflict With The Decisions Of This Court Or The Principles Of The Bankruptcy Code.

Petitioner claims the decision below is in conflict with Justice Harlan's opinion in *Neal v. Clark*, 95 U.S. 704, 709 (1877), and the longstanding principles and policies of federal bankruptcy law. The decision below is no more in conflict with *Neal* than was Justice Harlan's later opinion in *Strang v. Bradner*. *Neal* held that for a debt to be nondischargeable because it was created by fraud, the fraud had to be "actual fraud", as opposed to constructive fraud. *Strang*, following *Neal*, declared that a partner's "actual fraud" could be imputed to his co-partners to make a debt nondischargeable in bankruptcy even where the co-partner did not consent to his partner's fraudulent acts or had no knowledge or reason to have knowledge of these acts. Justice Harlan wrote in *Strang* as follows:

> Each partner was the agent and representative of the firm with reference to all business within the scope of the partnership. And if, in the conduct of partnership business, and with reference thereto, one partner makes false or fraudulent misrepresentations of fact to the jury of

> innocent persons who deal with him as representing the firm, and without notice of any limitations upon his general authority, his partners cannot escape pecuniary responsibility therefore upon the ground that such misrepresentations were made without their knowledge. This is especially so when, as in the case before us, the partners, who were not themselves guilty of wrong, received and appropriated the fruits of the fraudulent conduct of their associate in business.

Id. (citing several state cases and treatises on partnership law).

Prior to enactment of the Bankruptcy Code of 1978, federal case law construing the issue of imputed liability under Section 17(a)(2) of the Bankruptcy Act of 1898 (the "Act"), 11 U.S.C. § 35 (repealed 1978), unanimously followed the rule set forth in *Strang*. *See* discussion of pre-Code precedent in *In re Paolino*, 75 Bankr. 641, 647 (Bankr. E.D. Pa. 1987); *In re Walker*, 53 Bankr. 174 (Bankr. W.D. Mo. 1985) (*"Walker II"*); and *In re Gray*, 22 Bankr. 676 (Bankr. W.D. Wis. 1982). Additionally, prior to 1970, state courts had concurrent jurisdiction to determine the dischargeability of a debt under Section 17(a)(2). The state courts also unanimously held that fraud committed by an agent would render a debt nondischargeable as to a debtor-principal. *See, e.g., Griffin v. Bergeda*, 152 Tenn. 512, 279 S.W. 385 (1926). Respondent has found *no* pre-Code cases with contrary holdings.

The adoption of the Bankruptcy Code of 1978 did not change the *Strang* rule. Section 523(a)(2) of the Bankruptcy Code of 1978 is derived directly from Section

17(a)(2) of the Act. The legislative history of Section 523(a)(2)(A) notes that it was modified "only slightly" from former Section 17(a)(2). *The express intent of Congress was to codify existing case law construing Section 17(a)(2).* S. Rep. No. 95-989, 95th Cong., 2d Sess. 78; H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 364, *reprinted* in 1978 U.S. Code Cong. & Ad. News 5787, 5864, 6320. To the same effect, *see* 124 Cong. Rec. 3998 (1978) (statement of Rep. Edwards). The case law at the time Section 523(a)(2)(A) was enacted was absolutely clear: actual fraud committed by an agent (Ledford) would render the resulting debt nondischargeable as to the debtor-principal (Sikes).

Applying principles of statutory construction enunciated in *Pennsylvania Welfare Department v. Davenport,* 495 U.S. 552, 563 (1990) ("[W]e will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure."), together with the legislative history of § 523(a)(2), which indicates no intent to alter the statutory interpretation of § 17(a)(2), mandates that courts today follow the binding pre-Code cases decided under § 17(a)(2) of the Act. The majority of courts have done just that. *See* citations in *In re Luce,* 960 F.2d 1277 (5th Cir. 1992); *In re Calhoun,* 131 Bankr. 757 (Bankr. D.C. 1991); and *Paolino,* 75 Bankr. at 647. In *Walker II,* the court stated:

> [T]he fraud of an authorized agent, without more, has continually been recognized as a ground of non-dischargeability, although it takes the knowledge or reckless disregard of the principal to deny the latter's discharge in bankruptcy.

53 Bankr. at 179.

That the rule set forth in *Strang* is still good law is also confirmed by the leading bankruptcy commentator. 3 King, *Collier on Bankruptcy* ¶ 523.08 at 523-57 (15th ed. 1992). *Accord In re Cecchini*, 780 F.2d 1440, 1444 (9th Cir. 1986) (fraudulent partner's knowledge *and intent* imputed to co-partner for purposes of determining dischargeability); *In re Scheuer*, 125 Bankr. 584 (Bankr. C.D. Cal. 1991); *In re Yates*, 118 Bankr. 427 (Bankr. D.S.C. 1990); *In re Powell*, 95 Bankr. 236 (Bankr. S.D. Fla. 1989), *aff'd*, 108 Bankr. 343 (S.D. Fla. 1989) and *Powell v. Bear, Stearnes & Co.*, 914 F.2d 268 (11th Cir. 1990); *In re Smith*, 98 Bankr. 423 (Bankr. C.D. Ill. 1989); *In re Figge*, 94 Bankr. 654 (Bankr. C.D. Cal. 1988), *aff'd*, 928 F.2d 1136 (9th Cir. 1991); *In re Paolino*, 75 Bankr. 641 (Bankr. E.D. Pa. 1987); *In re Beleau*, 35 Bankr. 259 (Bankr. D.R.I. 1983).

II. The Conflict With The Eighth Circuit No Longer Has Any Practical Significance.

The Petitioner relies primarily on *Walker v. Citizens State Bank of Maryville, Missouri*, 726 F.2d 452, 454 (8th Cir. 1984) (*"Walker I"*) for his proposition that certiorari should be granted. Such reliance is misplaced. The *Walker I* decision has been the subject of continued and sharp criticism, beginning with the bankruptcy court which heard the case on remand.[3] That court pointed out that the Eighth Circuit erred by applying the standard for a pre-Code total denial of discharge case to a case that dealt

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[3] For a critical discussion undermining the reasoning of *Walker I* and the few decisions which have followed it *see Calhoun*, 131 Bankr. at 761; *Paolino*, 75 Bankr. at 648-49; and *Walker II*, 53 Bankr. at 179-81.

only with the dischargeability *of a particular debt created by fraud. Walker II,* 53 Bankr. 174. *See also In re Luce,* 960 F.2d 1277. Such confusion is perhaps understandable when it is realized that the parties in *Walker I* mistakenly briefed the case as if it involved a total objection to discharge, rather than the dischargeability of a particular debt created by fraud. *See Walker II* at 180. Under the Code, fraud no longer bars a *discharge,* but a particular debt created by fraud continues to be *nondischargeable.*

The few troubled decisions following *Walker I* have failed to articulate a persuasive basis for disregarding binding pre-Code precedent and the legislative history of Section 523(a)(2)(A). Moreover, like *Walker I,* they fail to distinguish the different purposes and assumptions underlying the particular issues in objection to discharge versus nondischargeability of debt cases. *See* Kennedy, *The Discharge of Partnerships and Partners Under the Bankruptcy Code,* 38 Vand. L.Rev. 857, 896 (1985) (exceptions from *dischargeability* are not designed as much to effect the conduct of the bankrupt as they are to protect certain classes of creditors from the loss of their just claims).

Recent decisions reject the erroneous reasoning of *Walker I* and continue to apply the well-established rule that fraud can be imputed to a partner regardless of his knowledge or involvement for purposes of determining the dischargeability of a debt created by fraud under Section 523(a)(2)(A). When the recent cases are reviewed and it is seen that the district and circuit courts now correctly follow pre-Code precedent, Petitioner's claim of conflict and confusion collapses.

III. There Is No Constitutional Question.

Sikes asserts that he was denied his constitutional right to due process because he has not been able to present evidence which might have shown Respondent failed to prove any of the elements of Section 523(a)(2)(A). Sikes' contention at this late date that he can come forward with additional evidence is belied by the fact that in the courts below he adopted the evidentiary arguments of his partner Ledford *in toto*. *See* Sikes' Reply Brief before the Sixth Circuit at pages 5-6 where Sikes adopted Ledford's evidentiary arguments:

> In his principle brief, Sikes adopted the entire brief of Ledford, including that portion of the brief concerning reasonable reliance under Bankruptcy Code section 523(a)(2)(A). Pursuant to Rule 28 (i) of the Federal Rules of Appellate Procedure, Sikes also hereby adopts by this reference the entire reply brief of the defendant-appellant, Thomas E. Ledford.

Rather than taking the opportunity at trial to present his "evidence", Sikes elected to move for dismissal at the close of BancBoston's proof. By making this election, he voluntarily relinquished his right to come forward with evidence because his motion was granted. *See* FED. R. CIV. P. 41(b).

The first time Sikes raised his due process issue was in his reply brief before the Sixth Circuit Court of Appeals. Sikes' procedural due process arguments are therefore not properly before this Court because they were not to timely raised in the courts below. *See Hormel v. Helvering*, 312 U.S. 552 (1941); *Singleton v. Wulff*, 428 U.S. 106, 120 (1976), *on remand*, 538 F.2d 811 (general rule

is that a federal appellate court does not consider an issue not passed on below). This issue should not be heard for the first time before the United States Supreme Court. Simply stated, Petitioner has presented no constitutional question. Therefore, this Court's intervention is unnecessary.

CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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App. 1

No. 91-5594/5649

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

In re: Thomas E. Ledford; J. Gregg Sikes
Debtors.

BancBoston Mortgage Corporation,
Plaintiff-Appellee,

vs.

Thomas E. Ledford and J. Gregg Sikes,
Defendants-Appellants.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE MIDDLE DISTRICT OF TENNESSEE NASHVILLE DIVISION

JOINT APPENDIX

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[p. 2-71] MOLTENI - RECROSS/SIKES - DIRECT

RECROSS EXAMINATION

BY MR. HANCOCK:

Q. What bank did you go to to get the LC?

A. First American.

Q. Did they require the usual financial statement information?

A. Yes.

Q. They required you to sign loan documents?

A. Yes.

Q. You made all the commitments that you would expect to make at the bank, did you not?

A. Right, yes.

MR. HANCOCK: No further questions, Your Honor.

THE COURT: You can step down, Mr. Molteni. Call your next witness.

MR. DAVIDSON: Your Honor, I call Dr. Gregg Sikes.

JAMES GREGORY SIKES, PLAINTIFF'S WITNESS, SWORN

DIRECT EXAMINATION

BY MR. DAVIDSON:

Q. Dr. Sikes, what is your occupation?

A. I'm a physician.

Q. Where do you practice?

A. At 356 25th Avenue North.

Q. You are a, or you were a general partner with Tom Ledford [p. 2-72] in Montclair, Limited. Is that correct?

A. That's correct.

Q. Prior to becoming a general partner in Montclair, you had entered into other financial dealings with Mr. Ledford.

A. That's correct.

Q. All right. And you were a joint venturer with Mr. Ledford in Timberlake Apartments, is that right?

A. I was a joint venturer.

Q. And you were a joint venturer with Mr. Ledford in – is it 325 Union Street?

A. That's correct.

Q. And you were also a partner with Mr. Ledford in Belmont Plaza, Limited?

A. Mr. Ledford was one of the general partners. I was a limited partner.

Q. Were you also involved with Mr. Ledford in Whispering Hills, Limited?

A. No, I was not.

Q. That was a real estate investment that you had gotten into prior to Montclair.

A. Not with Mr. Ledford.

Q. Excuse me?

A. Not with Mr. Ledford.

Q. All right. It was a real estate investment partnership that you had gotten into prior to the Montclair?

[p. 2-73] A. I was a limited partner in it.

Q. What about the Sunset Wind Park apartment complex in Memphis?

A. I helped arrange financing for the initial effort.

Q. Were you in with Mr. Ledford? Were you a partner in that?

A. Only in the initial phases of financial arrangements.

Q. And you were also an investor with Mr. Ledford in Eagle Oil and Gas.

A. As a limited partner.

Q. That was as a limited partner. All right. Now at the time you joined as a general partner of Montclair, you understood, did you not, the difference between a limited partner and a general partner?

A. Yes, I did.

Q. All right. And you signed loan documents with the bank as a general partner.

A. I signed documents.

Q. You signed those documents as a general partner of Montclair, Limited, did you not?

A. I believe that to be correct.

Q. All right. And you also signed a letter of credit with First American Bank as a general partner of Montclair, Limited, did you not?

A. I signed a letter of credit with First American Bank.

[p. 2-74] Q. Is it your contention that you didn't sign it as a general partner of Montclair?

A. I assumed I signed that personally.

Q. All right. But with regard to the Montclair, Limited, you helped to get financing for the project?

A. That's correct.

Q. All right. And you engaged with discussions with Mr. Ledford from time to time about marketing the project.

A. Mr. Ledford and I talked about marketing the project.

Q. And about raising capital?

A. I'm not sure I understand what you're asking.

Q. You assisted Mr. Ledford in raising funds for the Montclair project.

A. I helped secure a letter of credit from First American Bank.

Q. And you signed a personal guarantee for the debt of Montclair, Limited as a general partner.

A. I believe that to be correct.

Q. All right. Now, in spite of the fact that you were a general partner, it's true, is it not, that you relied on Mr. Ledford for the day-to-day management of the Montclair project?

A. That's correct.

Q. All right. And with regard to these presale contracts, you were relying on Mr. Ledford to obtain those presale contracts.

[p. 2-75] A. That's correct.

Q. You were aware, were you not, sir, that construction funding was a condition of the bank providing construction funding was that a certain number of presale contracts be obtained.

A. At some point between 1986 and now I was aware.

Q. Before the presale contracts were signed and you signed the loan documents, you were aware that there was a need to get presale contracts.

A. I was aware at some point there was a contingency of presale contracts before construction funds would be advanced.

Q. All right. What I'm asking you is, isn't it true you were aware of that before any construction funds were advanced?

A. I think that's correct.

Q. All right. And you were represented by counsel at the time you signed these loan documents?

A. Yes, I was.

Q. All right. The law firm of Bouldt, Cummings. Is that right?

A. Yes.

Q. Now, during the Fall of 1986 before you hired Mr. Mifflin to be your financial adviser, you were aware at least of one contract that had a contingency to it, were you not? The Phillip Molteni contract?

A. Yes, I was.

[p. 2-76] Q. And that was in the Fall of 1986.

A. It was before I hired Mr. Mifflin in 1987.

Q. When did you hire Mr. Mifflin?

A. I think in February 1987.

Q. And is it the Phillip Molteni agreement that you were aware had a contingency to it?

A. I believe that's been my stated testimony.

Q. Who told you that Mr. Molteni had this contingency?

A. Someone at Ledford Properties.

Q. And didn't Mr. Ledford tell you that?

A. It may have been, but it could have also been George Tomlin.

Q. All right. Say it could have been Mr. Tomlin?

A. Or Mr. Molteni; someone at Ledford Properties.

Q. Then in the Fall of 1987 you hired Mr. Al Mifflin to oversee all of your financial affairs?

A. That's correct.

Q. And shortly after you hired Mr. Mifflin, he met with Mr. Ledford.

A. That's correct.

Q. All right. And one of the things that he met with Mr. Ledford to discuss was the Montclair project?

A. Correct.

Q. Mr. Mifflin reported back to you about the meeting he had with Mr. Ledford.

[p. 2-77] A. Correct.

Q. And did he not tell you, at that time in February 1987 that of the contracts obtained five had contingencies, or outs, and that 11 did not?

A. I think – I think it was a later date. It was after I retained Mr. Mifflin. He did secure information requested

from Mr. Ledford and in a subsequent meeting with me did relate to me there were four to five contracts that had contingency agreements.

Q. Dr. Sikes, let me hand you -- let me first ask you, you remember I took your deposition in this case -

A. Yes, I do.

Q. - on or about November 10, 1989.

A. Yes.

Q. All right. Let me refer you to Page 19 of that, or let me ask you, do you remember me asking you this question?

> "What was your knowledge, what contingency did Mr. Molteni's contract contain?" Answer, "Selling his personal residence." Question, "Was this Mr. Phillip Molteni?" Answer, "Yes." Question, "How did you become aware of that contingency?" Answer, "Through Mr. Ledford."

Does that refresh your recollection about who told you about the Phillip Molteni contract?

A. That obviously was my stated testimony at that time. My [p. 2-78] testimony today is, I believe that to be correct that day, but it may well have been someone else in the office. Most of my conversations were with Mr. Ledford, but not all of my conversations.

Q. All right. Well, do you believe your memory would be better back in November 1989 or as you sit here today?

A. That may have not been a full answer at that time, but not necessarily an incorrect answer. I'm just trying to give you an honest answer.

Q. So you were trying to give me an honest answer on –

A. Both times.

Q. – November 10, 1989, were you not? Were you withholding information from me at that time?

A. No, I was not.

Q. Now, when Mr. Mifflin told that five of these contracts had contingencies, you knew prior to that time that these funds, the construction funds, were being advanced on the basis of the bank having received valid presale contracts.

A. I knew they were based on receiving a certain number of contracts.

Q. All right. Then you were aware that those contracts were not to have contingencies unless authorized by the bank.

A. I'm not sure I was aware of that.

Q. Did there come a time when you were aware of that?

A. Yes; when you started taking my deposition.

[p. 2-79] Q. Did you inquire of Mr. Ledford whether these contingencies, as he reported to Mr. Mifflin in February of 1987, were in any way violative of the bank's loan agreements?

A. I had no reason to ask him that. The construction funds had already been advanced based on those contracts. My assumption at that time, I don't think unfounded, was if the bank advanced the funds, those contracts were okay. I had no basis to ask Mr. Ledford if there was anything wrong with those contracts.

Q. All right. So to make sure I understand this, sometime before you hired Mr. Mifflin you were aware that there was a contingency with Mr. Phillip Molteni.

A. That's correct.

Q. Then in February, Mr. Mifflin met with Mr. Ledford and shortly thereafter you became aware that at least five contracts had contingencies. Despite that knowledge, you had no discussion with Mr. Ledford about this – well did you ever have discussion with Mr. Ledford about it?

A. Yes, I'm sure myself and/or Mr. Mifflin did because our concern at that point is regarding the contracts and contingencies, our only concern was closing contracts because the more contracts we closed, the more monies we had to pay down our liabilities in a project that we were becoming concerned about.

Q. And you stood to obtain 40 percent of the profits from [p. 2-80] this project, did you not?

A. That's correct.

Q. And you had entered a contract with Mr. Mifflin where he received seven percent of whatever profits you received.

A. He received a percentage of what my income is.

Q. All right. So if your income was 40 percent for the Montclair project, he would have received seven percent of that?

A. I think our contract was he received no percentage of any pre-existing business arrangements prior to our contract. He would not have received any money from the Montclair.

Q. Was it your understanding that he would not get paid for any services he rendered with respect to the Montclair?

A. Not from money that came in from the Montclair; that's correct.

Q. How was he to be compensated for the work he did with respect –

A. From my medical practice and the income I made from it.

Q. Did you make available to Mr. Mifflin the loan documents?

A. I gave Mr. Mifflin any documents that I may have had, which were few, and I requested Mr. Ledford that Mr. Mifflin was representing me in all financial affairs and matters, and I asked that he please submit over any documents that he may have for Mr. Mifflin's review.

Q. All right. As far as you know, Mr. Mifflin did review [p. 2-81] those loan documents?

A. As far as I'm aware, he reviewed what he received.

MR. DAVIDSON: I have no further questions, Your Honor.

THE COURT: Cross examine. Mr. Jennings, do you want to start? I guess this is direct examination.

MR. JENNINGS: Briefly, Your Honor, at this stage.

CROSS EXAMINATION

BY MR. JENNINGS:

Q. Dr. Sikes, were you involved in raising any funds relative to this project other than the letter of credits that you've testified about?

A. No, I was not.

Q. Were you involved in obtaining any contracts?

A. No, I was not.

Q. All right. What funds, Dr. Sikes, did you receive from the acquisition loan or the construction loan during this period of time?

A. I never received any money from either one of those.

Q. Have you received any money to this point?

A. No, I have not.

Q. All right, sir. Now, what was your role in this project?

A. My role was only to help secure financing which in the front end, I believed was to help secure a letter of

credit to apply against the financing from Bank of Boston to – for a [p. 2-82] construction loan.

Q. Did you do anything other that?

A. That's all I did.

Q. All right. What involvement did you have with Mr. Ledford as far as knowing what was going on relative to the project?

A. I would call Mr. Ledford either on a weekly or every other week, basically, and ask for updates as to how the project was going, meaning both construction, how coch [sic] (phonetic) sales were going. Sometimes, as relates to Montclair only, sometimes in conversations I was updating some other business deals we had at the time.

Q. And to your recollection, how often to you talk to Mr. Ledford about the affairs that you were involved in with Mr. Ledford?

A. Sometimes it might be once or twice a week and sometimes it might be every other week, but certainly we would talk in a matter of several times a month.

Q. All right. Why did you eventually retain Mr. Mifflin?

A. Because my nonmedical financial relationships and investments were taking too much time from my medical practice which I needed to spend time and I felt I needed some expertise to help manage that and to look into these and spend the time that I didn't have time to spend.

Q. Do you recall what contact you had with representatives [p. 2-83] of BancBoston prior to Mr. Mifflin's being retained?

A. Only on one occasion and that was when we signed the documents for the construction loan was the only person – the only time I ever met any representative of Bank of Boston, and that was a fellow who runs the local office. I don't remember his name. I first met Mr. Hudspeth when there was a – the project was completed and there was an opening night or a gala, he came up and introduced himself, which was my first introduction to him. Otherwise, I had no dealings at all with any of those people, either in person or in meetings. I never received correspondence, phone calls. It was all through Mr. Ledford.

MR. JENNINGS: I believe that's all right now, Your Honor.

THE COURT: Mr. Hancock, any questions?

MR. HANCOCK: No questions.

THE COURT: Mr. Davidson.

REDIRECT EXAMINATION

BY MR. DAVIDSON:

Q. Dr. Sikes, in these weekly or bi-weekly discussions with Mr. Ledford, you discussed the Montclair project?

A. That and also other projects.

Q. Did you have access to the files at Ledford Properties?

A. I'm sure if I had asked for them, I would have had access. I had no reason to ask for them.

Montclair

16 contracts out of 42 units
5 have outs – free option until May
11 don't – 7% of purchase price earnest money

Will get package & agreement
$6,225,000 total cost — Can Not Sell

Mrs. Sonnenfield is 88 years old

Model open in May

Ledford says he is not to secure ½ FANB
Note – Will clear w/Greg.

No Park Circle connection – 10 unit sale
has been accomplished

Completion – West End – Fredrich of Hooper

Sunset

Ledford says financing
⅓ of 20% once capital is restored
Capital probably will be restored in 90 days
90-10 split cash flow
80-20 – resale (Back end)

329 Union

Valued at what he has in it — Probably Can Not Sell

App. 18

Meeting 2/27/87

Montclair

The West End across the street – direct competitor – price same

16 Contracts in hand out of 42 units

5 can get out, have until May	11 can't – firm – owner/occupant Has cash or letters of credit averaging 7%

2 investor units for 140,000
142,000
144,900
149,900 – lowest price now
159,900 –
239,900 – 3rd floor corner

6,225,000 total cost

House & Lot – 5 to 6 townhomes could be built
Occupant is 88 yrs. old
Value – 8,200 sq. ft. to build
185,000 (would ask 200,000)

Greg should net 480,000

Model open in May
Everything ready for occupancy – July.